FINAL REPORT OF
THE MANITOBA
LOWER TAX COMMISSION

January, 2000

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1. PREAMBLE

TERMS OF REFERENCE

The Lower Tax Commission was struck in May 1999 by the former Progressive Conservative government. Its mandate continued under the New Democratic government in September of 1999. The Commission's original and only terms of reference are stated as follows:

> "The task of the Lower Tax Commission is to generate ideas, consult with Manitobans, and then provide options for a tax system for Manitoba that not only reduces the tax burden, but is fairer, simpler, and competitive.
>
> In light of the Government's responsibility to balance the Budget every year, to make payments against the debt, and to provide Manitobans with important services such as health care and education, the Commission will provide analysis and options to the Government on the following issues:
>
> (a) **Tax Competitiveness**: The Commission will consider how Manitoba's tax environment compares with other relevant jurisdictions, and suggest which taxes most influence Manitoba's competitiveness. The scope of their work will include personal, sales, corporate, and property tax.
>
> (b) **Tax Mix**: The Commission will consider whether Manitoba's mixture of taxes is appropriate, and advise on priorities for tax cuts. It will also consider the relative merits of targeted versus general tax reductions.
>
> (c) **Tax on Income**: Provinces will soon be able to levy personal income taxes directly on taxable income, rather than on basic federal tax. Such a system will give Manitoba the opportunity to simplify our tax system by doing away with the net income tax and the surtax. The Commission will advise on the design of a Tax on Income system for Manitoba, including the following issues: the number and level of tax brackets (including the possibility of a flat tax); refundable and non-refundable tax credits; the levels for the basic personal and spousal exemptions; and the tax treatment of families where one parent stays home with their children."
>
> Terms of Reference, May 1999

PUBLIC CONSULTATIONS AND RESOURCE REFERENCES

The Commission has consulted with Manitobans through public meetings and has received over 400 submissions by mail, email, and telephone on ways Manitoba's tax system can be improved. The Commission has taken into account these submissions from the public, all relevant data on the details of the tax system provided by officials of the Finance Department, and results of professional research on the tax system and its effects carried out in Manitoba and elsewhere. Consult the Appendices included in this report for further information.

REPORTING PERIOD

The Commission was called on to report back to the government before year end. The commitment to implement a Tax on Income system was confirmed by the government, in order to ensure implementation of the new taxation system by the Year 2001.

BACKGROUND: FACTORS LEADING TO PROVINCIAL TAX REFORM

Manitoba's tax system has a major influence on the health of our economy and the well-being of all Manitobans. A healthier economy generates more financial resources for governments to provide health care, education, and other vital services that Manitobans value. In short, a tax system which is simpler, fairer and more competitive and which contributes in a positive way to the health of our economy, will help secure our future.

By contrast, a tax system can negatively effect the economy. High taxes can dampen our productivity and our desire to work, to innovate, to save for the future. High taxes will drive some legitimate activity underground, leaving the rest of the economy to carry a heavier tax burden. When high tax rates cause the most mobile Manitobans to seek greener (after-tax) pastures, the province has the potential to lose on many fronts: neighbours, co-workers, innovators, entrepreneurs and, of course, taxpayers. Provincial economic growth suffers, which in turn affects the level of salaries paid and ultimately our standard of living.

Over the past thirty years numerous tax changes initiated primarily by the federal government have levied more and more tax, using tax legislation and tax forms of increasing complexity, as both federal and provincial governments have struggled to overcome large increases in spending followed by rapidly mounting debt problems.

Today, over one tenth of Manitoba's own-source revenue is committed just to paying interest on the outstanding general purpose debt of the provincial government. The share for the federal government is three times as high. Canadian taxpayers have continued to pay dearly for this collective mortgage: higher taxes have reduced after-tax income levels relative to other jurisdictions.

However, there is now the prospect of tax relief. Elimination of deficit spending has resulted in budgets at or close to balance, which means that debt and debt service charges are no longer growing as fast as or faster than the tax base. Whenever debt service payments stay constant and tax revenues grow, governments have new "tax room" to lower tax rates in at least some areas, without lowering spending on programs.

It is unclear as to the available tax room Manitoba will have in the future, but Ontario and Alberta expect sufficient room that they plan to lower tax rates aggressively. The Saskatchewan Tax Commission proposed its own aggressive tax reduction in self defense. The availability of tax room in Manitoba depends in part on the province's willingness to continue to balance budgets and to reduce interest expenditure, and on the willingness of the federal government to adjust transfers such as Equalization Payments and direct program funding.

Now is therefore an excellent time to review the whole provincial revenue system, particularly in light of Manitoba's decision to levy personal income taxes under the new Tax on Income approach. It is the right time to reflect upon whether we have the right provincial "tax mix".

"Tax mix" refers to the share of revenues the government raises through/with different types of tax. In Manitoba, the four main types of tax are personal income tax, business tax, sales tax and property tax.

The right tax mix for Manitoba can improve the performance of our economy, leading to higher levels of prosperity, and even higher revenue surpluses. The right choices in reducing taxes within our taxation mix can stimulate the creation of more physical and human capital. The optimal tax mix will not only provide most Manitobans with real opportunities for personal growth - it will also maintain and even expand the tax base so that we can better afford the social services we desire within our communities.

2. EXECUTIVE SUMMARY

> "The task of the Lower Tax Commission is to generate ideas, consult with Manitobans, and then provide options for a tax system for Manitoba that not only reduces the tax burden, but is fairer, simpler, and competitive." (*Terms of Reference* of the Lower Tax Commission)

The Commission began its task by stimulating Manitobans' thinking on their tax system through five discussion papers and a provocative brochure that was mailed to everyone across the province in the summer.

We have received valuable feedback in response, both in public hearings in the fall and in hundreds of written submissions on all aspects of the tax system and beyond, from individuals and organizations all over the province. The Commission has considered all of this public input. We have reviewed the major forces that will change Manitoba's revenue needs and prospects over the next decade. They include a relatively favorable outlook for the world economy, the threat of more vigorous tax competition for Manitobans from other jurisdictions, looming future increases in the costs of caring for an aging population, and a shortage of skilled employees that could stall the growth of too many of the small and medium sized firms that dominate Manitoba's diversified economy.

We considered each major tax field in detail in the process of assessing the fairness, simplicity, and competitiveness of each type of tax to see which should play larger or smaller roles in future government finance, and to find where tax reductions and improvements could be found. In assessing fairness, we looked closely at exactly what is required by our current conception of taxing "according to ability to pay," and interpreted it to mean rising average tax rates as a share of total income.

Personal income tax: We found the Personal Income Tax in Manitoba to be reasonably fair but not fair enough, in that it does not always place a similar tax burden on those in similar circumstances, and sometimes taxes those with no ability to pay. It is too complex, and dangerous to the province's competitiveness and therefore to its future. In decisions to migrate, people focus mostly upon the personal income tax. Manitoba's marginal personal income tax rates are much higher than in the most important destination provinces.

Residential property tax: Residential property taxes are widely and correctly seen as unfair in that they are not well connected to ability to pay by any common definition. While the extra complexity caused by the provincial Education Support Levy is very small, significant extra complexity is added to the provincial income tax as a by-product, because of the property tax credits designed to correct unfairness. The provincial Education Support Levy has little effect on provincial competitiveness.

Consumption taxes: Consumption taxes are relatively fair, particularly if levied in conjunction with a credit for non-discretionary consumption. They are also relatively simple, and do not seem to cost much in extra competitiveness.

Business taxes: The burden of business taxes is unfairly distributed both across firms and across customers of taxed firms. Consumption taxes levied directly on goods or services are fairer in that the tax burden is more transparent, and the worst inequities can be offset by appropriate exemptions and tax credits.

The corporate income tax stands out as the most complex of all business taxes, but because of federal provisions, Manitoba can do little about this complexity. Where Manitoba stands to gain more simplicity is from harmonizing the PST with the GST, and realizing the savings of government and firms administering a single sales tax. What stands in the way is loss of revenue currently raised by Manitoba's PST from business inputs - significantly more than in any other province.

Business taxes do have significant competitiveness impacts, to the extent that they raise domestic producers' costs above those of rivals out of province. However, it is the comparison of total costs of doing business that is important, and not the comparison of individual taxes. The payroll tax stands out as the one most likely to interfere with the province's long-term economic growth.

General Recommendations:

The Commission's general recommendations for the overall tax mix are:

- That the tax system be made simpler by changing to the Tax on Income system, in order to remove the net income tax and surtax and surtax reduction credits.
- That the tax system be made fairer by adjusting basic personal amounts to reflect more closely what non-discretionary consumption actually costs in Manitoba.
- That the tax system be made more competitive by reducing personal income tax rates.
- That the tax system be made both fairer and simpler by removing both the residential portion of the provincial property tax, and the property tax credits on the income tax form that go with it.
- That the tax system be made simpler and fairer and more competitive, by moving away from sales taxes on business inputs, towards an ultimately harmonized sales tax system.
- That where the desired changes above exceed the amount of tax room available after paying the costs of public services government decides it must provide, the consumption taxes be increased to make up the shortfall.

The extent to which these recommendations would change the tax mix depends on how far we need to go to improve competitiveness in the future. Our competitiveness will be influenced by the success Alberta and Ontario have in fulfilling their current intentions of slashing personal income taxes, the degree to which Saskatchewan does likewise in self defense, and the degree to which tax gaps matter to migration flows between provinces. We recommend two models of change.

Model 1: The Balanced Growth Model

Our proposals for this model assume less competitive pressure due to one of two circumstances: either Alberta and Ontario do not achieve their current tax reduction plans, or migration proves relatively insensitive to tax rate differences.

In this context we propose a marginal Personal Income Tax (PIT) rate of 14% up to $150,000 of taxable income, and 17% thereafter. We propose a structure of basic allowances that reflect the actual cost of non-discretionary consumption for families of all types and sizes. We also propose a significant extra tax credit for the first four years after graduation for those skilled employees working in Manitoba, in order to reduce the marginal tax rate to fully competitive levels for a valuable and particularly mobile group. These changes will result in Personal Income Tax reductions at most income levels.

We also propose reductions in property tax and business taxes mentioned above. Initially the latter would take the form of removing sales taxes on production machinery, but eventually we would move the province to a harmonized sales tax.

Model 2: The Reactive Growth Model

Our proposals for this model assume that Alberta and Ontario do achieve their tax-cutting plans, and that migration is very sensitive to tax gaps.

In this context we propose a single tax rate, 11%, to apply to all taxable income in order to prevent excessive out-migration to other provinces with even lower general taxes. At such a low marginal rate we do not propose any extra tax credit for recent graduates, but we still propose the same fairer basic allowances, and the same reductions in property and business taxes as in Model 1.

Other changes:

We recommend many more detailed changes in individual taxes, to correct features that do not seem justified by our three criteria of fairness, simplicity, and competitiveness. All of the recommendations are listed below.

Conclusion:

Our recommendations offer significant tax reductions to Manitobans and significant improvements to the tax system, while attempting to maintain a prudent balance as between social and economic policy.

SUMMARY OF RECOMMENDATIONS

Recommendation # 1:

We recommend the continued reliance on user fees where benefits can be directly attributed to specific taxpayers.

Recommendation # 2:

We recommend that in general Manitoba should resist temptation to provide new support through new personal income tax credits, as simplicity is quickly compromised under complex credit systems.

Recommendation # 3:

We recommend that government adopt a budgeting process similar to that used by many businesses, where tax rates are set and revenues are estimated first, and then expenses are constrained to fit estimated revenues.

Recommendation # 4:

We recommend that the government implement the recommendations contained in this report by the Year 2002 and consider a temporary increase in the PST to fund provisions that will be financed later out of growing tax room.

Recommendation # 5:

We recommend a neutral non-distorting tax system in which businesses and investors face roughly the same tax burden regardless of their sector of the economy.

Recommendation # 6:

We recommend that, where possible, methods other than the income tax system be used to redistribute income to needy families in Manitoba.

Recommendation # 7:

We recommend that earned income be sheltered from income tax by a tax credit until income exceeds non-discretionary consumption needs.

Recommendation # 8:

We recommend that the basic tax credit amounts be $7,700 each for the taxpayer and spouse or spousal equivalent, and $3,300 for each child, with a supplemental tax credit of $3,300 for all taxpayers living without spouse or equivalent.

Recommendation # 9:

We recommend that the provincial government urge the federal government to adjust its basic tax credit amounts in line with the costs of non-discretionary consumption for households of different types. and to increase its employment expense deduction to reflect better the true costs of employment.

Recommendation # 10:

We recommend that either under the circumstances of Model 1, or as an interim measure toward Model 2, the government set an income tax rate of 14% for all non-sheltered taxable income up to $150,000, and 17% thereafter.

Recommendation # 11:

We recommend that under the circumstances of Model 2, the government set an income tax rate of 11% for all non-sheltered taxable income.

Recommendation # 12:

We recommend that the government add to the Tax on Income system a Post-Secondary Graduation Tax Credit with the following features:

- equal to half of provincial tax payable;
- available only for the four tax years following graduation from a post-secondary program of two years or more;
- available for programs completed in Manitoba or elsewhere;
- electable only once, for graduation from one program;
- capped at $5,000 per year.

Recommendation # 13:

We recommend that the Labor-Sponsored Funds credit and the new Manitoba Equity Tax Credit be continued in their current form.

Recommendation # 14:

We recommend that the Cost of Living Tax Credit be renamed the Provincial Sales Tax Credit, and set at levels that reflect consumption taxes paid on non-discretionary consumption.

Recommendation # 15:

We recommend that the province terminate the Learning Tax Credit.

Recommendation # 16:

We recommend that the government index the tax credit amounts and brackets to increases in the cost of living, measured as the inflation rate of the Consumer Price Index less 1%.

Recommendation # 17:

We recommend that the residential portion of the provincial Education Support Levy be removed from property tax bills on residences and cottage properties.

Recommendation # 18:

We recommend that as it removes the residential portion of the Education Support Levy, the province also remove the system of property tax credits. including Homeowners' School Tax Assistance from its personal income tax system.

Recommendation # 19:

We recommend that the province extend its existing shelter allowance programs to compensate those low-income or elderly homeowners or renters who would on balance lose from the changes recommended above.

Recommendation # 20:

We recommend that the changes to the property tax and related credits be implemented for 2002.

Recommendation # 21:

We recommend that for the three years following removal of the residential portion of the Education Support Levy, the government impose a freeze on property taxes assessed by municipalities and school boards, with appropriate allowance for such changes as they may need to improve the fairness of their property tax systems.

Recommendation # 22:

We recommend that the government no longer issue licenses that exempt life lease apartments from education taxes of any sort, that those licenses currently in place be revoked on a "suite-by-suite" basis upon the first turn-over of any suite, and that government instead provide any necessary support through the existing shelter allowance programs.

Recommendation # 23:

We recommend that the previously announced schedule of corporate income tax reductions be followed.

Recommendation # 24:

We recommend that the province shift gradually away from levying sales tax on business inputs, and that it begin this process by exempting production machinery from the provincial sales tax.

Recommendation #25:

We recommend that the payroll tax be given high priority as the business tax to lower, when extra tax room becomes available.

Recommendation # 26:

We recommend that the clawback of the $1 m. exemption from the payroll tax be spread over the next $3 m. rather than just the next $1 m. of payroll.

Recommendation # 27:

We recommend that the province move to harmonize its sales tax with the GST over a five year period, starting with the phased removal of the PST from business inputs.

Recommendation # 28:

We recommend that the sales tax rebate for new home buyers be shelved.

Recommendation # 29:

We recommend that the provincial government urge the federal government to allow families some extra contribution room in RRSPs, to reflect years when one spouse stayed out of the labor force to look after young children or aging relatives.

3. THANKS TO MANITOBANS

The Lower Tax Commission wishes to thank the many Manitobans who took the time to communicate their concerns regarding Manitoba's tax system, whether by mail, by email, by telephone, or orally at the public hearings. While the submissions varied considerably, the views expressed can be summarized as follows:

Manitobans generally feel that our personal income tax system is relatively fair, but not always simple or competitive. Few Manitobans object strongly to the sales tax system, but many feel the property tax is unfair, particularly the very high levels of education tax imposed on all residences, including cottages. Many Manitobans are attracted to the one-rate tax system that will be introduced soon in Alberta. Few were clear on how fairness is, or should be, defined, and opinions varied greatly on the likelihood of people moving into or out of the province just for tax reasons.

Some views were common only within specific groups:

(a) *low income individuals*: With regard to personal income taxation at low income levels, there were very few complaints from the recipients of refundable tax credits, and some support for enhancement. However, some questioned whether our "negative income tax" was as effective as it could be in reaching those it is designed to help - especially children. Others, who saw themselves as spokespersons for those with lower incomes, opposed any tax cuts because they assumed that any attempt to lower taxes must automatically mean cutting benefits to low-income individuals as well.

> *"A fair tax system does not redistribute tax dollars. It allows for a "zero tax bracket" for those who are financially unable to contribute. A zero tax bracket and no tax credits would be fairer, simpler and encourage employment."*
>
> Rosalie Schmidt, Winnipeg

On the property tax side, many senior, low-income property owners were outraged by the recent rate of growth and the current size of their property tax bills. They made special reference to their school taxes, particularly the local school division portion.

> *"It is ever more apparent that property taxes are not the appropriate tax source to fund education."*
>
> Fredrick Petrie, Winnipeg

(b) *mid to higher income individuals*: Opinions on personal income tax for incomes over $30,000 varied among taxpayers. Many objected to high personal income taxation levels, and to insufficient tax credits or exemptions for staying at home to raise young children. Some worried that the mobile will leave the province if higher paying jobs were offered in other jurisdictions and that lower taxation elsewhere may increase out-migration. Surprisingly, one or two stated they were willing to pay more if it was necessary to preserve fairness and the current level of services.

> *"If there are to be targeted reductions, the targets should be precisely those who now pay - the so-called middle-class, and not those who don't."*
>
> Michael Luke, Pinawa

There was less concern over property, sales and consumption taxes than over the personal income tax system.

(c) small businesses: Small businesses in Manitoba expressed a real fear of losing skilled employees and of being unable to attract skilled employees from other jurisdictions. They perceived an increasing gap in productivity, attributed to high personal tax rates, and considered high taxes a deterrent to both risk and innovation. Worse, they saw future businesses looking elsewhere specifically due to lower taxation in other jurisdictions. Taxes which are insensitive to a firm's profits, like sales taxes on business inputs, payroll or capital taxes, were seen as unfair in relation to taxes tied to corporate income.

> *"Small business enterprises are the job creation engine of the Manitoba economy. It is disturbing to know that 7.3% of Manitoba's small businesses are now actively considering moving to another province."*
>
> Canadian Federation of Independent Business

(d) large firms: Overall, representatives of large firms emphasized the importance of reducing personal rather than corporate income taxes, in order to attract and keep the skilled but highly mobile employees that large firms also need here in Manitoba. While payroll and capital taxes were issues for financial institutions, it was conceded that a tax holiday or reduction in this area would not necessarily encourage quick relocations to this province.

> *"Without targeted changes in its tax structure, Manitoba faces significant obstacles to its interprovincial and international competitiveness"*
>
> Canadian Bankers Association.

(e) unions: The unions' presentations rejected outright any lowering of taxes that would be achieved by cutting spending programs. Their spokespersons were skeptical of claims that higher taxes in Manitoba would cause significant out-migration even of the mobile, so they saw Manitoba's tax system as only lightly constrained by considerations of competitiveness.

> *"A truly fair tax system, based on the ability to pay principle, will tax excessive wealth at higher rates than income needed to meet living expenses."*
>
> Canadian Union of Public Employees

(f) school boards: School board representatives along with teachers' unions regarded any restriction on school boards' right to levy local school taxes as a serious infringement on their local autonomy, blamed boards' financing woes squarely on perceived or actual provincial government cutbacks, and worried that any tax cut might cause less support for spending programs in education.

> *"A new Manitoba income tax should act in a direct and assured manner to alleviate child poverty."* Manitoba Teachers' Society

The views of Manitobans who took the time to express their concerns and suggestions have helped the Commission to identify the key issues in our tax system and to focus on those improvements which would make it fairer, simpler and more competitive.

4. CONCEPTUAL FRAMEWORK

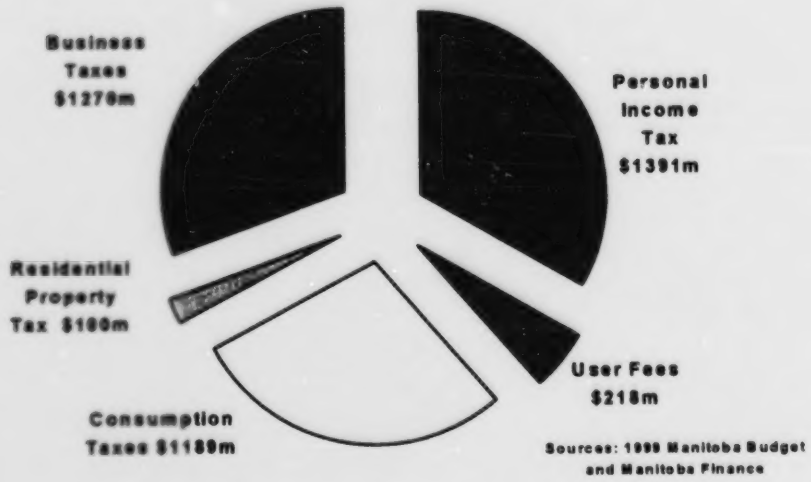
It is our task to recommend how tax revenues should be raised in the future. In the past, the purpose of our tax system has been two-fold:

- to raise revenues to finance publicly-provided services and
- to redistribute tax revenue, through transfer payments to persons and businesses

The provincial government raises revenue from many different tax sources, with each tax having its own set of details regarding who pays and how much. The reform of a whole tax system is therefore a daunting task, one not carried out federally or provincially since the 1960s.

To make our task more understandable both to ourselves and to readers of this report, the Commission has found it useful to group all provincial own-source revenues into five categories: personal income tax, business/corporate taxes, consumption taxes, residential property taxes, and user fees. The relative size of these five categories is shown in the chart below, with some breakdowns in the text box below that. We ignore the 30% of provincial revenues that are derived from federal transfer payments, including Equalization Payments. Clearly, the three tax bases that produce the most revenue are personal income tax, consumption taxes and business taxes.

SHARES OF TOTAL OWN-SOURCE REVENUES
MANITOBA 1998/99


Business Taxes $1270m
Personal Income Tax $1391m
Residential Property Tax $180m
User Fees $218m
Consumption Taxes $1189m
Sources: 1999 Manitoba Budget and Manitoba Finance

Definitions of Categories: Residential Property tax is the portion of the Education Support Levy applied to residential property, and does not flow into the Consolidated Revenue Fund. **Personal income tax** excludes an estimated $89m of business income tax paid by unincorporated businesses. **User Fees** include all Fees and Other Revenue. **Consumption taxes** include the estimated consumption goods share of the Provincial Sales Tax ($540m), taxes on gasoline and tobacco, and the revenues of the Lotteries Corporation and the Liquor Control Commission. **Business taxes** include the corporate income tax ($228m), the estimated $89m of business income tax on unincorporated firms, the estimated 40% share of the Retail Sales Tax that is paid on business inputs ($360m), the part of the Education Support Levy paid on commercial property ($120m, that does not come into the Consolidated Revenue Fund), and taxes on payroll ($225m), capital ($114m), motive fuels, insurance corporations, mining, and a few other small taxes.

Revenues Based on the Benefit Principle: The Commission considers user fee revenues differently from other sources. User fees are payments for specific government services such as driver licensing, hunting licensing and park use fees, that are levied only on the beneficiaries, according to the value of services rendered. Where they can be applied, the justification for user fees is the same as the justification for market pricing of services provided through the private sector: the benefit principle of payment in proportion to benefits we receive. Each dollar raised through user fees is a dollar less that must be raised in the major tax fields under consideration in this report, each of which does some harm to the economy's competitiveness.

Recommendation # 1:

We therefore recommend the continued reliance on user fees where benefits can be directly attributed to specific taxpayers.

Evaluation of Taxes: It is a central feature of the major tax fields that the amounts paid by each taxpayer will not generally be related to specific services provided to that person. Taxes that cannot be evaluated on the benefit principle, must be evaluated on some other criteria. The aim must be to evaluate each tax, and the tax mix as a whole, according to the effects it has on individuals in the economy and society.

Methods of Evaluation. The three criteria identified in the Commission's terms of reference have assisted us in evaluating the best use and effectiveness of each primary tax base, and capture their effects on the economy and society. To the extent possible, we would like each type of tax to be:

- Fair;
- Simple; and,
- Competitive.

The Commission has found it helpful to define clearly each of these three criteria. While there are likely other definitions, the Commission has used the following:

- **A Fair Tax System** is free of bias. It places a similar tax burden on those in similar circumstances. It places a greater tax burden on those with greater ability to pay. It places no burden at all on those just able to afford what society considers to be the minimum basic necessities of life. All three features must be clearly visible to taxpayers if the tax is to be seen to be fair. The tax system therefore must be simple. A fair tax system is reasonably predictable over time, and its rules are not applied retroactively.
- **A Simple Tax System** is one that is readily understandable by taxpayers.
- **A Competitive Tax System** is one which leads people and businesses to believe they are receiving sufficient after-tax return on their labor and their investments. As a result, they will continue to work and to invest their savings in Manitoba. What they consider to be sufficient is of course influenced by what they see in other jurisdictions. Competitiveness, therefore, is a relative--not an absolute--concept, that changes over time. It is anticipated, for example, that what was competitive in 1995 will no longer be competitive in 2005, since taxes in rival provinces are projected to be much lower in 2005, and mobility will probably have increased significantly.

  Uncompetitive taxes are revealed by their consequences: people somehow avoid the activities being taxed, whether by going underground, or putting out less effort, or moving the activity outside the province to a more tax friendly jurisdiction.

Of the tax fields we are considering in the report, each will score differently on any of these three criteria. For example, the fairest tax system is not likely to be the most competitive, since skilled individuals with substantial ability to pay are often those who can most readily move to jurisdictions with lower taxes. As another example, the simplest tax system is unlikely to be the fairest, since many specific tax provisions that promote a fairer sharing of the tax burden also make the tax more complex.

Application of Criteria: The Evaluation Process. Before recommending any change in the tax system, the Commission has gone through the process of :

- identifying how the recommended change affects fairness, simplicity and competitiveness,
- judging the relative importance of each type of effect, to see whether on balance the change is a net improvement, and
- comparing the net benefits of that change with the net benefits of other changes that could be made instead.

We go through this process repeatedly to reach the recommendations contained in this report.

Alternatives to Taxation: Governments use the tax system to achieve both economic and social objectives. The tax system is not the only means of achieving these objectives.

Elements of economic policy can be achieved through:

- the taxation system
- program incentives (grants, subsidies)
- regulatory policy, including labor legislation

Elements of social policy can be achieved through:

- the taxation system
- explicit subsidies/entitlements
- providing benefits in kind

These alternatives must be kept in mind in the re-engineering of a taxation system.

Exclusions and Limitations: The Commission's terms of reference require us to consider only tax systems sufficient to

> "balance the Budget every year, to make payments against the debt, and to provide Manitobans with important services such as health care and education."

We interpret that as putting outside our mandate all questions as to what is the proper range of government expenditures, or even what it ought to cost the government to provide those important services. We received many submissions on both subjects, but will not comment on either one in this report.

One aspect of the tax system also falls outside our mandate. The property tax revenue raised by the provincial government (known formally as the Education Support Levy), is only a small part of total property tax revenue raised. Much more is raised by municipal governments and school boards. We do not consider that our mandate extends to a review of municipal or local school board finance, so we make no recommendations as to their taxing policies.

5. THE CONTEXT FOR TAX REFORM

The first step toward the redesign of Manitoba's tax system is to look ahead at what the future holds for the province. This section provides a thumbnail sketch of some of the major factors or considerations the Commissioners see driving Manitoba's economy and its tax revenue over the next ten years, relative to the past 10 years. We classify them into Strengths, Weaknesses, Opportunities, and Threats, and present them in that order. The table lists the factors in each category, and the discussion that follows explains the consideration in more detail, including its effects upon Manitoba's tax policy.

Strengths, Weaknesses, Opportunities and Threats

for the Years to 2010

Strengths	Weaknesses	Opportunities	Threats
1. Economic diversification	1. Demands on the social safety net	1. Proliferation of vibrant small to medium-size firms	1. Vigorous tax competition
2. Supply of entrepreneurs	2. Low salary/earnings levels	2. The shrinking debt burden	2. Immediate shortage of skilled employees
3. Macroeconomic stability	3. Small local markets	3. A demographic pause	
		4. Infotech and mobility	

Strength 1: Economic diversification. Manitoba has a widely diversified economy, and we expect the economy to be as diversified over the next decade as it is at present. A wide range of manufacturing sectors will continue to employ many Manitobans; agriculture will be split between livestock and grain farming; exports will be spread over many different sectors, with no one sector dominant. Most employment will continue to occur in the service sector.

Into the future, we expect Manitobans to maintain a comparative advantage in many different sectors, leading to continuing growth.

Effects on Tax Revenues and Policy: Economic diversification brings lower risk, less volatility in provincial revenues than would otherwise be expected. The downside of the stability described above is the unlikelihood of dramatic increases in provincial revenue. Therefore, the tax system must be designed to be sustainable right from the start: in Manitoba we will not be rescued from any deficits by surging oil royalties or corporate tax windfalls.

Strength 2: Supply of entrepreneurs. The community will continue to develop a stock of entrepreneurs sufficient to start a wide range of new ventures. Our economy has become as diversified as it is over the last century largely because of our own home-grown entrepreneurs, rather than due to the plans of foreign investors. We have no shortage of seeds and planters.

What follows from this strength in combination with our economic diversification, is that the province has no single economic sector that is an obvious center of gravity on which the government should focus as the growth pole. In fact, entrepreneurship, rather than a particular sector, is the center of gravity upon which future growth will rest.

Without sufficient job creation by these entrepreneurs, career prospects will be too poor to allow many of Manitoba's young people to stay. When asked, many young people say that they want to live and work in Manitoba, to keep the same high quality of life with which they are familiar. However, unless their skills are in demand, by the firms that only entrepreneurs can start up and grow, many will never have that opportunity. Instead, too many of our youth will become part of the silent drift to other provinces' opportunities.

Effects on Tax Revenues and Policy: Government-generated advantages for business will have to be general, not targeted to specific sectors. Investments in technology, research and development, including new methods of delivery or cost-reduction, and new management-employee skills and knowledge will be necessary for businesses to compete. Flatter tax rates should be considered to reduce mobility of entrepreneurs and their employees.

Strength 3. Macroeconomic stability. The macroeconomic picture to 2010 looks more promising than a similar outlook for the previous three decades, despite the length of the current expansion. The technological revolution in communication that is still working through the North American economies should produce rapid growth in productivity over the next twenty years. While there are some dangers to sustained growth of world demand for Manitoba's exports over the next decade, they seem no more serious than the shocks of 1998, which the Canadian and Manitoban economies as a whole have weathered fairly well. As long as Canada keeps a flexible exchange rate, a declining Canadian dollar will continue to mask decreases in our productivity, and we will continue to be able to offset the impact of most trade shocks to our volume of trade and compete in world markets, even if only at a lower exchange rate (and standard of living). The province's share of a growing world economy therefore seems no less secure or insecure for 2010 than it has been over the past decade.

Effects on Tax Revenue and Policy: First, provinces that expect healthy and steady growth of taxable activity in their economy over the next decade can afford to make larger commitments to tax reductions or new spending programs today than would otherwise be possible. Second, in such a bullish environment, tax reductions are more likely to stimulate investment in human and physical capital, as was the case in the 1960s. Only such an investment will allow the economy (and government revenues) to continue to grow over the next decade.

Weakness 1. Demands on the social safety net. Manitoba will continue to have a significant group of families drawing on our social programs. Many of these families will include young children who will be growing up with significant disadvantages. These families will continue to cause a large draw on our social programs.

Effects on Tax Revenue and Policy: If social program spending grows more rapidly than the tax base, then the tax room that would otherwise open up as the tax base grows will be eaten up instead by other spending programs. This must not be allowed to happen. Therefore we must be prudent in the way that social programs are financed to ensure that they are effective and affordable, particularly during this window of opportunity in which demands on health care will be relatively stable (See Opportunity 3).

Weakness 2. Low salary and earnings levels. The structure of the Manitoba economy includes lower income sectors than exist in Ontario and Alberta. Few of the markets in which Manitobans must compete have the high prices and barriers to entry of the oil or automobile industries, or even the headquarters of the financial sector. The result is a lower real wage level in Manitoba.

Effect on Tax Revenue and Policy. This can produce out-migration and a lower tax base, particularly if there is not an offsetting influx of large firms which will choose to migrate to take advantage of lower real wages. Many corporate head offices in Ontario and Alberta continue to draw our hi-tech, management and professional graduates with higher salary levels. To keep these graduates, we must develop similar high-income management and technical support positions by growing our own mid-range firms.

On the other hand, reasonable labor costs will be a factor in encouraging growing firms to continue to locate in Manitoba. Our tax policies should not only make it possible for Manitoba-based firms to grow larger, but also for salaries of employees in those firms to grow to attract and keep the brightest graduates.

Tax reductions for individuals can go a long way in that direction. So can efforts to encourage investment in Manitoba companies, and targeted tax relief for those who decide to stake their future in Manitoba.

Weakness 3. Small local markets. While our migration data show significant gross migration into Manitoba--three times as many people migrate into Manitoba each year, on average, as are added to the population by natural increase—we have a small and isolated marketplace, when compared to that of southern Ontario, Alberta or British Columbia.

Effect on Tax Revenue and Policy. In order to grow, it is vital for Manitoba businesses to reach other markets. Tax policy should under no circumstances present competitive barriers to national and international trade. If the burden of a business tax is borne more heavily by owners of exporting firms, for instance, that business tax should be removed. Tax policy should also encourage access to the technology, delivery systems and communications systems that will make it possible for Manitobans to do business around the world, right from here.

Opportunity 1. Proliferation of small to medium-size firms. As the vast majority of Manitoba businesses will be small to medium size in the near future, their owner-managers will be directly concerned over the personal income tax rates for themselves, as well as for their staff. There is also a foreseeable need to manage small business ownership transitions, and include family and employees in succession plans to broaden and secure home-grown ownership.

Effects on Tax Revenue and Policy: The rate of tax on personal income, investment earnings and capital is as important a tax on business income as the corporate income tax. Certain specific tax provisions may also encourage employee, intergenerational and community equity ownership, profit-sharing and wealth creation, as well as Manitoba-based succession of business ownership on the retirement of the owner.

Opportunity 2. The shrinking debt burden. Continued economic growth at sustainable rates, as we have had over the last five years, will reduce the burden of debt service in dollar terms. Debt repayments at the current rate of $96 m. per year will lower the outstanding debt on which interest must be paid, though even over ten years this amount will repay only 15% of current general purpose debt. However, if taxable incomes and taxable consumption spending grow at 3.8% per year (as widely forecast), the debt service payments left will take only 5.5% of the Manitoba government's own-source income, down by half from 11 % now. This can increase tax room by well over $300 m. per year by the Year 2010.

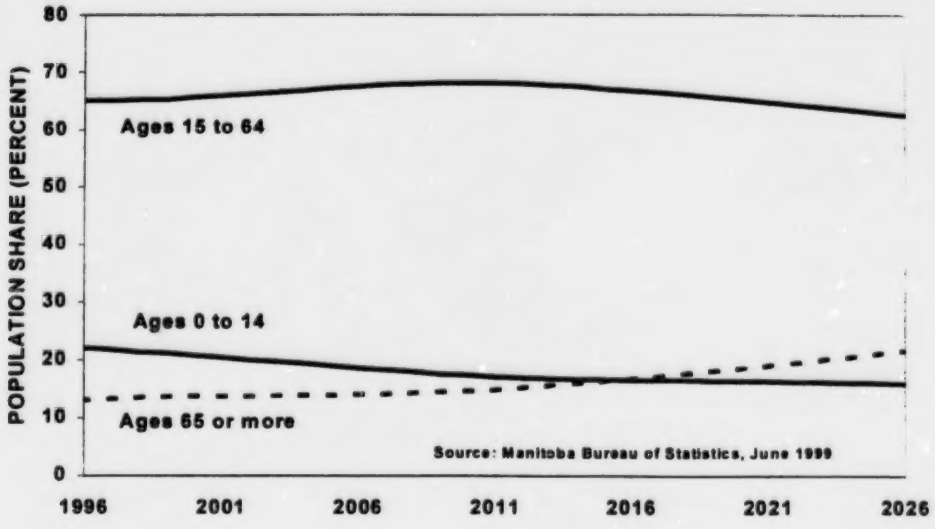
Effects on Tax Revenue and Policy: If growth of social program spending does not grow faster than the tax base, there will be surpluses of well over $300 m. per year by 2010, even before considering any savings possible through efficiencies. These sums can be handed back in tax cuts.

Opportunity 3. A demographic pause. Population developments over the decade are likely to create some extra tax room as well, though not permanently. The aging of the population over this decade will mean fewer children to educate: the Manitoba Bureau of Statistics and Statistics Canada medium projection is for the share of the 0-14 age group to fall by almost three percentage points. The share of the 65+ age group will rise, but by less than one percentage point. So the dependency ratio will fall somewhat over the next decade. The baby boomers will still be largely of working age by 2010, still in their high-income, high-saving years and not yet making large demands on the health care sector. It follows that demand for the government's education and health programs, driven by the young and the old respectively, should grow slowly relative to the tax base.

Thereafter the dependency ratio will start to rise, especially as a result of a rising share of the elderly, but the rise does not start till 2010. More importantly, there will be a rapid rise that goes on for two decades thereafter, as the baby boom hits retirement and the small cohort after it makes up the entire labor force.

Effects on Tax Revenue and Policy: The calm period to 2010 is therefore the lull before the storm, and must be used to prepare. . .to lower the provincial debt relative to GDP, for example. Reducing tax rates is essential to prepare for the time when big pension benefit demands—and higher health service costs--collide with a smaller labor force. The Figure below shows the demographic forecast to the year 2026.

DEMOGRAPHIC FORECAST FOR MANITOBA
MEDIUM PROJECTION, 1996 TO 2026



We have time to lower our debt to income ratio, and build up the Fiscal Stabilization Fund. We also have the time to train the labor force we will need to fill positions of demand in the future: engineers, technicians, doctors, nurses, home care and other service providers, to encourage business starts to service the new demographic needs, and to make Manitoba an attractive place for retiring baby boomers to invest and spend their savings.

Opportunity 4. Infotech and mobility. Over time, current trends in information technology will increasingly weaken the connection between place of work and place of residence. We see some of this phenomenon in the form of people living outside the city and commuting downtown--only electronically. We will see more of this trend inter-provincially: people living in Winnipeg and working online for customers in Calgary and Toronto, and vice versa.

By 2010 we can expect such behavior to be much more common. In such a world, losing jobs in Winnipeg will no longer necessarily mean losing an equivalent number of residents, and gaining work activity will not automatically bring a matching influx of new residents to the province.

Effects on Tax Revenue and Policy: Physical mobility will no longer be as closely tied to better job prospects; rather other considerations will become more important. Manitobans who lose their jobs may not have to move elsewhere, if they have the skills to compete for jobs in other provinces while maintaining residences here.

As long as Manitobans are in the province, their consumption, property taxes and income taxes flow to this provincial government. Therefore it is important that Manitoba's tax environment is friendly over the long term, to benefit from possibly diminished threats of out-migration due to innovation within the new economy.

Threat 1. Vigorous tax competition. Interprovincial tax competition occurs when one province has to respond to the tax policies of another in order to cope with positive and negative consequences that arise due to the other's tax policies. Inter-jurisdictional tax competition can affect the flow of labor, capital, goods and services, and tends to affect smaller economies more dramatically than larger ones. Therefore this is an important issue for Manitoba.

Alberta and Ontario will likely stay ahead of Manitoba in average income, and in reduced average tax rates. Persistent natural advantages and the cumulative effects of rapid in-migration in the past are both paying off for these provinces. Until the North American economy runs into a severe recession (something that will happen sooner or later, but not foreseen as of January 2000), these two economies are likely to continue to draw away some skilled Manitobans and some Manitoba employers.

At best, Winnipeg is not likely to experience the kind of rapid economic growth and expansion that Calgary and Toronto have experienced in the past, as families migrated from the rest of the country, resulting in a housing sector explosion. At worst, a very large tax gap will open up between Manitoba and the two rich provinces, and out-migration flows of skilled labor and capital will resume on a very much larger scale than would have been predicted from the past. In *Appendix C* we review the evidence on migration flows over the last decade, and estimate roughly what is to be expected for the future.

Effects on Tax Revenue and Policy: Manitoba will have to pay even more attention to keeping its income tax rates no more than some maximum distance from those of Alberta and Ontario, for the sake of competitiveness, even if we find personal income taxes generally a fairer source of taxation and would prefer to rely more on them rather than less.

Threat 2: Immediate shortage of skilled individuals. Manitoba business owners have told the Commission there is an immediate shortage of skilled labor that represents an impediment to growth. In addition, barriers to international immigration into Manitoba are a part of this problem.

Effect on Tax Revenue and Policy: The ability to increase future tax bases is threatened by this shortage of skilled people. Put more succinctly, any impediment to the growth of the economy is an impediment to the tax base.

6. EVALUATION OF THE OVERALL TAX MIX

In this section we evaluate each of the four major tax fields according to our criteria of fairness, simplicity and competitiveness, as defined in *Section 4 Conceptual Framework*. The results of this evaluation create two primary recommendations for change within the overall tax mix. These are presented in the next section. We will also provide more detailed recommendations on individual taxes within each tax category, in later sections.

A. Evaluation of Personal Income Taxes

1. Fairness:

Under our criteria for fairness, the personal income tax system must have the following characteristics:

- It must be free of bias and place a similar tax burden on those in similar circumstances.
- It must place a greater tax burden on those with a greater ability to pay.
- It must not place a burden on those able to afford only the basic necessities of life.
- It must be simple to understand and reasonably predictable.

The first characteristic, also known as horizontal fairness, is achieved if people pay similar tax when they have similar ability to pay. The base upon which we levy personal income taxes corresponds fairly well with the generally accepted definition of ability to pay: personal income from all sources, less allowances for non-discretionary consumption.

Federal Constraints: It is important to point out that the definition of taxable income is one of several features of the income tax system that are set for us by the federal government. Other features include the choice as to whether income will be taxed on an individual or a family basis, whether the joint federal and provincial income-tested tax credits will be clawed back on the basis of individual or family income, how the joint tax credits will be indexed for price inflation, and what provision will be made to average out fluctuations in taxable income from one year to the next. Provincial amounts for the personal credits that the federal government also uses must be at least equal to the federal amounts.

We make recommendations affecting several of these features in later parts of this report, particularly in *Sections 7 and 8*.

Progressivity: Many complain about how quickly the personal income tax rises with income this is also known as vertical fairness. All seem agreed that vertical fairness requires the average tax rate to rise with total income levels. Such progressivity is achieved even by a "one-rate" tax system that has only a zero-tax bracket or exemption or threshold amount, and one tax rate for all taxable income above that level.

Beyond that minimum degree of progressivity, opinions about what is "fair" progressivity differ widely among experts and among the general public. Some textbooks in public finance define progressivity as rising *average* tax rates, some define it as rising *marginal* tax rates.

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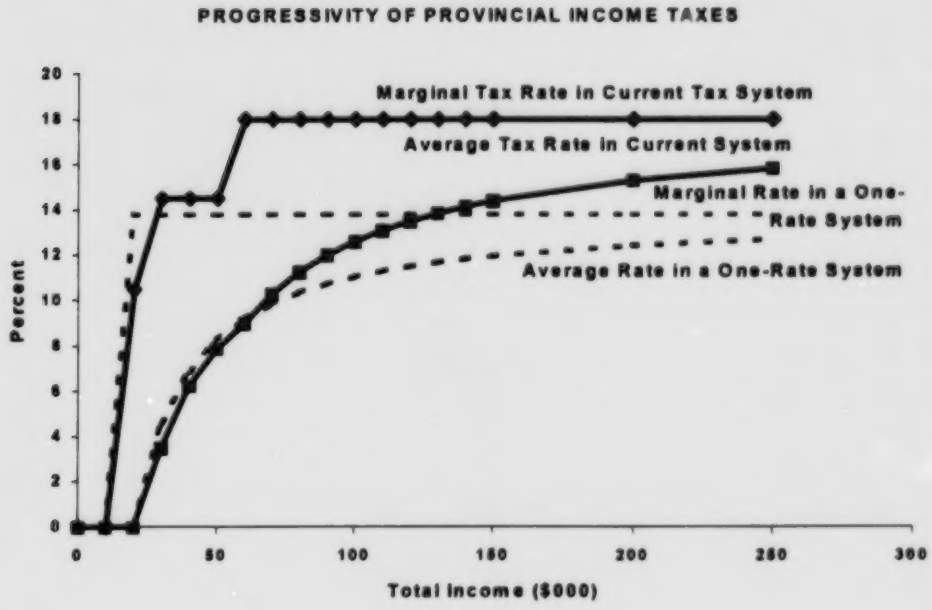
When asked about the fairest degree of progressivity of personal income taxes, most presenters to the Commission did not distinguish between rising average tax rates and rising marginal tax rates.[1]

The chart below shows the difference.



The Commission's view is that the personal income tax burden should increase in proportion to ability to pay, and we define ability to pay as the amount of personal income above that needed for non-discretionary spending. What follows is that we should have one tax rate for all taxable income in excess of non-discretionary consumption. Only with such a tax rate structure will total tax rise as fast as ability to pay and no faster. As the chart shows, the *average tax rate* would still rise with total income: each taxpayer pays no tax on the basic income needed for non-discretionary consumption, and this is a much smaller share of total income for high-income households.

[1] Bruce Davie and Bruce Duncombe, *Public Finance* (New York: Holt, Rinehart & Winston, 1972; A. B. Atkinson and J. E. Stiglitz, *Lectures in Public Economics* (New York: McGraw-Hill, 1980).

The current tax system has a series of rising marginal tax rates, which cause each taxpayer's total tax to rise faster than their ability to pay. We do not understand what justifies such a structure of tax rates. To help readers with this issue, we include a summary of the possible justifications for rising marginal tax rates, from a well known economics text. Every one of them is hard to defend:

> "Perhaps the rich, being fewer in number, were outvoted. Perhaps each successive marginal dollar is presumed to be less essential to the rich person's welfare, making it "ethical" or fair that the rich pay more. Perhaps the rich save a larger percentage of income from consumption than others, so that to encourage spending and reduce saving and investing we tax the rich more. Perhaps the rest of the tax structure is biased against the poorer people . . . so the income tax is graduated upward to compensate. Or perhaps because the rich have more wealth, they have more to gain from government protection from foreign and domestic aggressors and, therefore, should pay higher taxes, even disproportionately higher. Take your pick."[2]

Since we have no real justification for increasing tax faster than the ability to pay, we therefore see little justification in rising marginal rates if the average tax rates rise sufficiently. What follows from this--and public attitudes revealed to the Commission--is that Manitoba could move towards a flatter structure of marginal tax rates and still have a vertically fair income tax system, by most people's understanding of the term.

Basic Allowances: A more serious type of vertical unfairness in the current personal income tax system results when taxes start at individual and household income levels well below the amount necessary to provide minimum non-discretionary consumption for the household.

Our calculations for Manitoba, using the approach from a joint federal-provincial working group and price data from Manitoba Agriculture's Budget Guides, suggest that the minimum cost of non-discretionary consumption is $11,000 for the first adult in a household, $4,400 for each extra adult or the first child in a single-parent household, and $3,300 for each extra child. The calculations are to be found in *Appendix E* of this report.

By contrast, the current federal tax credit amounts are only $7,131 for the first adult in a household, $6,055 for the next dependent adult or spouse equivalent and $0 for each extra child. The chart below compares total cost of non-discretionary consumption and total federal tax credits available, cumulating the amounts shown above for families of different sizes. The differences are large, except for two-person families. All other families are effectively paying tax on some income needed to pay for non-discretionary consumption.

Overall, the personal income tax is seen to be a fair tax, in that people generally do pay more if they have greater ability to pay. However, taxable income and the current tax

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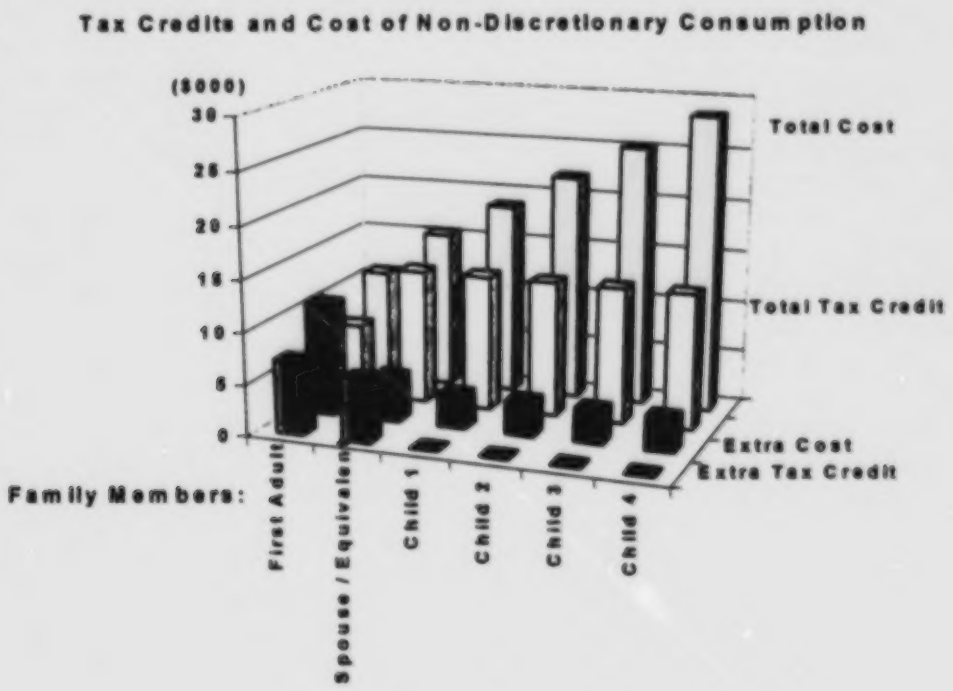
[2] Armen Alchian and William Allen, *Exchange & Production, Competition Coordination & Control* (Belmont CA: Wadsworth Inc., 1983).

credit structure exaggerate ability to pay for some households, and underestimate it for others.



2. Simplicity:

Is Manitoba's current tax system readily understandable? Manitoba's income tax credits are complex relative to other provinces, in part because Manitoba redistributes much more income via tax credits than do other provinces. In 1997, for instance, Manitoba's provincial tax credits and rebates per capita were $114 (excluding the property tax credit), Ontario's were $91 and the nearest province after that was British Columbia at $13. These numbers do not include any business credits.

In addition, Manitoba's present tax system is complex due to the net income tax and surtax system that the province put in place to provide more progressivity than was built into Basic Federal Tax. Such complexities will no longer exist when we move to the new Tax on Income system.

Much of what complexity remains is due to the property tax rebate system. Property tax credits are bound to be complex just because the application of property tax is complex: different administrative arrangements must be made for renters and homeowners, for instance.

In the future, we will be required to retain a system of provincial non-refundable tax credits at least as large as those kept by the federal government. This is one of the terms of moving to the new Tax on Income system. The province will have the option,

however to provide extra provincial tax credit amounts or new supplemental credits over and above the federal amount, if it perceives the federal amount is not adequate to shelter non-discretionary consumption from tax.

Recommendation # 2:

The Commission recommends that in general Manitoba should resist temptation to provide new support through new personal income tax credits, as simplicity is quickly compromised under complex credit systems.

3. Competitiveness:

> *"Whatever its rationale, the graduated income tax is known by analysis and evidence to reduce the incentive to work, reduce savings available for investment, and encourage more use of non-market income. . .there is evidence that as much as 20% of national income is hidden by underground market activity."*[3]

Tax on personal income has effects on several decisions individuals may make that are ultimately important to the province's welfare: whether to stay or leave, whether to work more or less, whether to spend now or save for the future, whether to go underground to save paying taxes, while risking detection and penalties, and whether to seek more education and training. All of these decisions affect our economic growth. The size of these effects is not at all clear. What is clear is that Canada has the highest personal tax burden of the G7 nations. *Appendix C* reviews the limited evidence on the sensitivity of migration to tax changes. *Appendix D* reviews the much more abundant evidence on sensitivity of work effort to tax rates. The issues are explained below.

Migration: The greatest threat of out-migration appears to be coming from the young (see *Appendix C*). This is of course where the migration costs to the province are most serious, as we lose the use of their skills over the remainder of a long working career.

Further, the groups whose out-migration appears to impose the greatest threats to the economy are skilled young professionals, especially those in the information technology field. All business groups identified skilled labor shortages as the most serious problem constraining Manitoba firms, and the reduction of PIT rates as the factor that would have the most favourable impact on enticing people to accept job offers in the province.

These "at risk" groups are most mobile right after graduation, and then decreasingly so as they put down more roots in the community. To begin, these young people are middle- rather than high-income earners. They would expect to reach high incomes before long, noticing, no doubt, high marginal PIT rates at high income levels even if they are not at these such income levels yet. Therefore the tax that would most need to be reduced to maintain competitiveness with rival provinces is the PIT.

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[3] Armen Alchian & William Allen, *Exchange & Production, Competition Coordination & Control* (Belmont CA: Wadsworth Inc., 1983).

For Manitoba's many small and unincorporated business owners, the PIT is also their "business tax". High personal income tax rates will cause some of these entrepreneurs to look for greener personal tax pastures in which to grow their businesses. This kind of migration means lost job opportunities in Manitoba for many others. We know that job opportunities are the main factor known to cause significant interprovincial and international migration flows.

It seems that it is personal income tax rates, especially the top marginal rate, that matter most when people are comparing provincial taxes in order to decide whether to migrate elsewhere.

Work Effort: It is well known that increasing income taxes reduce incentives for work effort. High marginal tax rates add to the disincentives for parents to rejoin the labor force: the additional income of a second-earner spouse in a family with children is eroded by federal/provincial tax credit clawbacks, income taxes payable, and EI and CPP contributions, on top of after-tax costs of child care and employment expenses such as clothing and transportation.

Empirical estimates of the extent to which reported hours worked will respond to changes in after-tax wages are in fact quite small (i.e. a 10% change in wage rate can cause a 1% change in hours worked). This is a lower-bound estimate, however. There will be further effects on productivity or on effort that are not measured.

Spending and Savings: Differential tax rates on different savings vehicles have dramatic effects on where savings flow, however. Continued favorable tax treatment of savings vehicles that channel savings into Manitoba investments will therefore raise Manitoba's growth even if total saving is not changed. (*Appendix D* shows the evidence for changes in savings habits over the last several years due to tax treatment of different savings vehicles.)

The personal income tax is applied to interest, dividends and capital gains, as well as rental income. High taxation levels affect the ability of individuals to accumulate capital, which can ultimately affect growth within an economy. While Manitoba must accept the federal government's definition of taxable income, concerns over reduced investment due to high taxation levels can be addressed by continuing those tax credits that reward savings directed explicitly toward investments in Manitoba, like labor-sponsored venture capital funds or equity tax credits.

Investment in Education: Investing in education is as important an investment decision as choosing a stock portfolio or building a new plant. Modern theories of economic growth in fact rank it a more important investment than new plants, since it is mainly the collaboration of skilled people working together that spark new ideas leading to innovations.

A well educated, trained labor force is consistent with high and growing living standards; a poorly educated, untrained labor force is not. Increasing knowledge so that Manitobans can be more innovative and productive is vitally important to the growth of Manitobans' incomes in the future. This will be especially important over the next 25 years while the

baby boomers retire from the labor force. Provincial growth will need to come from enhanced productivity rather than rising employment levels.

Investment in human capital is partly a financial decision taking into account the benefits of higher salary after graduation and the costs of tuition and foregone income until graduation. Income taxes reduce the benefits. Marginal income tax rates that rise with income bite harder on the higher income to be earned from more education than they do on the lower income to be earned without it. High and rising marginal income tax rates therefore work against heavily subsidized tuition rates for post-secondary education. which are designed to make returns to additional education more attractive.

Summary (Personal Income Tax):

The Commission has found that the Personal Income Tax in Manitoba could be fairer. simpler and more competitive for the future.

The Personal Income Tax is seen to be a fair tax overall, in that those with greater ability to pay, do pay more. However, taxable income and current tax credit structure exaggerate ability to pay for some households, and under-estimate it for others. It therefore does not always place a similar tax burden on those in similar circumstances, and sometimes taxes those with no ability to pay.

Manitoba's current personal income tax system is too complex - much more so than that of other provinces.

The personal income tax has several effects, of which the most important is out-migration, on the competitiveness and growth of the Manitoba economy. In decisions to migrate, the personal income tax is the tax that matters most, and Manitoba's marginal personal income tax rates are much higher than in the most important destination provinces.

B. Evaluation of the Residential Property Tax

We evaluate commercial property tax (levied on business property) separately from residential property tax (levied on homes and apartment buildings). Commercial property tax is evaluated along with all other business taxes because it is likely to be borne by the same groups. In this section we evaluate only the residential property tax, the payers of which we call ratepayers.

1. Fairness:

Of all the types of tax, the residential property tax was easily the most frequently criticized in the submissions made to the Commission. Part of the unpopularity of this tax has to do with unfairnesses in the tax itself. Part of the criticism has to do with other irritants entirely, and should not be blamed directly on the property tax. For instance,

- Many Manitoba citizens are unhappy with the whole system of local school administration, which they find unaccountable.
- Many ratepayers, as payers of property tax are called, are also unhappy with school boards being financed through property taxes, because property tax levies by some local school boards have risen quickly to levels that lower-income, retired ratepayers could not have expected and find acutely painful.
- Many cottage owners are outraged that they should be asked to pay taxes to a school division for whose school board they cannot even vote.
- Finally, the total property tax reflects levies applied by three different levels of government (province, municipalities, and school boards). Ratepayers have not been clear as to which level of government to hold accountable when the total tax burden has risen too quickly.

The property tax itself is widely seen as unfair, both horizontally and vertically.

Horizontal unfairness: People earning similar income pay widely different amounts of property tax, depending on the location of their property, on whether they live in a house or an apartment, on whether they own a cottage, and whether that cottage is on owned land or land leased for long terms in a provincial park. Those living in rented apartments will pay significantly lower property tax than those living in condominiums. A lucky few living in licensed life-lease apartments will pay much lower taxes still.

Where market value assessment of residential properties is not current, as in many areas, different ratepayers with very similar housing often pay different taxes.

There is no simple justification for any of these disparities except perhaps for the extra tax on those who own cottages as a second home (families with cottages can enjoy two residences, while families without enjoy just one).

A few ratepayers continue to think of education taxes as being justified only by the benefit principle, under which education taxes would be paid only by those with children to educate. These people feel unfairly treated even when they pay the same taxes as others of similar income or property. Their logic may be faulty, but their sense of grievance is real.

Vertical unfairness: Does the property tax burden rise with ability to pay?

The consumption-based view. A household's ability to pay can be and sometimes is measured (roughly) by its total discretionary consumption. That is why consumption taxes seem reasonably fair. If a household's consumption of shelter is roughly a constant fraction of its total consumption each year, and is also assumed to be a constant fraction of the current market value of its residential property, then property taxes that rise proportionally with market value of residential property are also rising proportionally with both housing and total consumption, and therefore with ability to pay. That is vertically fair.

Such a consumption-based justification for property taxes, however, is not at all transparent. Few people think of residential property taxes as just a different form of consumption tax on housing, however logical it may be. Also, few people think of those living in Vancouver, for instance, as consuming three times more housing than those in Winnipeg just because Vancouver property values are three times higher.

The wealth-based view. Many see those with higher residential property values as just having higher wealth, and evaluate the vertical fairness of the property tax as though it were a tax on wealth. The residential property tax would fail such an evaluation on two grounds.

First, it taxes only the market value of the real estate assets, and ignores financial assets. Even if we recognize that interest and dividend income from financial assets is taxed instead by income tax (whereas both capital gains and the annual shelter value of owner-occupied housing are not) and even if these two disparities roughly cancel out, it is still true that illiquid capital gains on the value of other assets are not taxed until the asset is sold (that is, liquidated). In contrast, illiquid residential property value is taxed every year even if it is not sold. For many elderly couples, annual property taxes cause a serious liquidity problem.

Second, the meaning of wealth or equity or net worth is defined as total assets less total liabilities, not just as total assets. Any young homeowner with a large house value and almost as large a mortgage appreciates the difference. Residential property tax is levied on gross residential property value, with no allowance for any debts that may be outstanding against those values. Nor is interest on such mortgages deductible under the income tax, as in the United States.

The income-based view. Most of us measure ability to pay by income, and we mean current income rather than some kind of lifetime average. For our conclusion on this view we quote from Boadway and Kitchen's most recent study of the Canadian tax system: "If one uses annual family income as the index of [ability to pay], the property tax is definitely regressive."[4]

Boadway and Kitchen's conclusion is based on the experience of two groups: young adults and the elderly. "Evidence on income distribution from Statistics Canada suggests that lower-income households tend to be dominated by young adults and the elderly.

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[4] Robin Boadway and Harry Kitchen, *The Canadian Tax System* (Toronto: Canadian tax Foundation, 3rd ed., 1999).

Young adults who are in the early stages of their income-earning careers but who have expectations for higher incomes in the future are likely to be housed in accommodation that reflects their expected income rather than their current income." The elderly, at the opposite end of their careers, are likely to be housed in accommodation that reflects their higher past incomes rather than their reduced current retirement income; they are house-rich but income-poor. For both groups, property taxes will be high relative to current income.

By all three possible bases for thinking about the fairness of the residential property tax, it is vertically unfair.

2. Simplicity:

Residential property tax liability is calculated by multiplying a property value assessment by a Portion, and that in turn by a mill rate.

- The property value assessment is intended to reflect market values for all property, regardless of class. Market value assessment is not an exact science even in principle, and the practice has been a bone of contention for decades all over North America. Assessment formulae are beyond the comprehension of most ratepayers.
- The Portion is fixed by provincial government legislation and varies by class of property in ways that are historic in nature, and not easily understood.
- The mill rate is set by the taxing authority (province, municipality, school board).
- The provincial mill rate (ESL) has been fixed over several years, but municipal and school board mill rates are set at whatever rate is needed to raise necessary revenue.

Once calculated (and barring appeals of the assessment), property taxes are relatively easy to collect and enforce, with low compliance costs. Both types of costs -- of calculation and of enforcement -- are almost entirely independent of whether or not the province continues to add its Education Support Levy (ESL) to the municipal and school board levies.

The presence of a provincial property tax adds considerable complexity to the provincial income tax, because at present it is accompanied by a complex property tax credit system. Property tax credits are needed to offset the inequities resulting from all shelter assets being taxed by the provincial residential property tax (ESL), with no allowance for non-discretionary amounts.

3. Competitiveness:

The Commission believes that the property tax is not an important barrier to competitiveness in Manitoba.

Some seniors might migrate out of province because of the height of residential property taxes, but not many. The over 60 group has accounted for only 5.6% of total out-migration from Manitoba over the last ten years , and their out-migration accounts for

only 6% of the their total in the population as a whole. By contrast, out-migration of the 20-34 age group over the same period accounts for 39% of their total population. It is unlikely that many in the younger age categories would move because of property taxes, particularly since properties in other jurisdictions with lower taxes mostly have much higher purchase prices as well.

Disparities in property tax rates do cause significant out-migration around city boundaries, because people can migrate without changing jobs or even social groups. Existing disparities are causing large-scale household migration out of Winnipeg, among households of all ages, and imposing significant extra costs from inefficient city development. However, these disparities are caused entirely by municipal and school board taxes, since the provincial Education Support Levy is a constant mill rate across all residential property in the province.

Summary (Residential property tax):

Residential property taxes are widely and correctly seen as unfair, both horizontally and vertically. They are not well connected to ability to pay by any common definition. They are also extremely complex to calculate, though the extra complexity caused by the provincial Education Support Levy is very small. Significant extra complexity is added to the provincial income tax as a by-product, because of the need for property tax credits. The provincial Education Support Levy has little effect on provincial competitiveness. Removing the Education Support Levy from residential property would improve the fairness and complexity of Manitoba's tax system, with little cost in competitiveness.

C. Evaluation of Consumption Taxes

Consumption taxes include not only the Provincial Sales Tax (PST), but also taxes on alcohol, tobacco, gambling, and gasoline. The three "sin" taxes amount to nearly half of what is raised in PST revenues. Some 40% of Manitoba's PST revenues come from taxes on business inputs - by far the highest ratio of any province. PST on business inputs is analyzed along with all other taxes on business (in part D of this Section), rather than here as a consumption tax.

1. Fairness:

The PST is a progressive tax because those with lower incomes spend a higher percentage of their income on items exempt from the PST, such as housing, groceries, medicine and children's clothing. Consumption taxes in general in Manitoba apply almost exclusively to spending on goods (other than those noted above),while most services are still exempt from PST, even though taxed under the federal GST.

Spending of each taxpayer on the remaining taxable goods is a reasonably fair measure of ability to pay, as long as there is some allowance for the principle that non-discretionary consumption amounts should not be taxable.

The federal GST credit is such an allowance, and Manitoba's Cost of Living Tax Credit is the provincial equivalent. Current consumption taxes, together with an appropriate PST credit to refund the taxes that would be paid on non-discretionary consumption and PST exemptions, turn a proportional tax into a progressive tax which is based on ability to pay, and which many regard as reasonably fair.

Some experts regard consumption taxes as a useful complement to income taxes precisely because they use a measure of ability to pay that properly captures some taxpayers who would escape paying their fair share under an income tax system. For example, those financing an opulent lifestyle by running down inherited wealth, and those spending illegal and unreported income will both pay hefty consumption taxes but no income tax.[5] Alternative Minimum Tax provisions are attempts to achieve the same objective within the income tax system, at the cost of greater complexity.

Gasoline taxes raise a difficult fairness issue because highway travel is an essential and expensive part of rural existence in Manitoba, while Winnipeggers have the option of using public transit. Gasoline taxes are therefore taxing spending whose first $1,500 is much closer to non-discretionary consumption for rural households than it is for city residents. There is therefore a case to be made that if consumption taxes are to be relied on more, as in Europe, gasoline taxes might be treated differently than the other consumption taxes to ensure rural people are treated fairly.

The analysis above assumes that all consumption taxes are in fact passed on to consumers. That will not be the case where consumers have the option of shifting their business to suppliers not subject to the PST. E-commerce and tourism are two categories of spending likely to satisfy those conditions. In those cases, provincial suppliers or their

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[5] Robin Boadway and Harry Kitchen, *The Canadian Tax System* (Toronto: Canadian Tax Foundation, 3rd ed., 1999)

employees will be forced to swallow some of the PST in lower profits or wages. Lower profits eventually mean lower values of their businesses. Such uneven distribution of the burden across producers is of course unfair.

2. Simplicity:

The Manitoba Provincial Sales Tax is relatively easy to administer, because it has relatively few exemptions. There is still some duplication of effort in having both provincial and federal collection of two fairly similar sales taxes, a duplication that exists only in Canada.[6] Moving towards a harmonized tax system, collected by just one agency, would require that we extend the consumption tax base to include many more services. Furthermore, all provincial sales tax on business inputs would be removed. The net cost to Manitoba provincial revenues is estimated to be $100 m. per year.

3. Competitiveness:

Consumption taxes are a surprisingly non-distortionary tax, considering how much we pay each year. There is no evidence that differences in consumption taxes cause perceptible migration flows even to Alberta, which has no provincial sales tax. Some shopping migrates, of course, and more will do so in the short term with the spread of e-commerce until the tax collectors find a way to clamp down reliably on such tax leakage.

Consumption taxes do reduce after tax rewards for work effort, in real terms, by raising the cost of those items we would buy with after-tax nominal income. However, consumption taxes are levied a few cents here and a few dollars there, they are very seldom seen in total. As well, consumption taxes are discretionary for anyone in that they can avoid them by saving instead.

The most important distortion may well be the one that is impossible to measure: moving sales underground to avoid the tax, at considerable cost to provincial revenues, to the evaders themselves (in extra efforts to keep their business activities hidden), and to their more honest business rivals. Without a level playing field, the honest business person who pays all taxes cannot compete with the price offered by the tax evader. Since sales of services are harder to monitor than sales of goods, consumption tax evasion could become a more serious cost if we extend the PST to include more services. It is therefore critical that our tax system is not so punitive that the taxpayers flee the system.

Supporters of consumption taxes claim important benefits from the fact that consumption taxes exempt saving while income taxes do not (except for the allowance for RRSP and RPP contributions). Savings represent deferred consumption, which is taxed at some later date and should not be taxed twice. Supporters also claim that higher savings rates will cause higher investment rates, and therefore higher levels of capital formation for future businesses and their employees. Some even claim higher investment levels will bring permanently higher economic growth rates, because investment activity is an important source of new innovations. There is strong evidence that higher savings rates in Canada cause higher investment rates in Canada; national borders are a significant barrier even for savings flows. However, there is no evidence that higher saving in

[6] Public Policy Forum with Plamondon & Associates Inc., *Cutting the Costs of Tax Collection Down to Size*. Dec 1997

Manitoba will cause higher investment in Manitoba. Savings in Canada seem to flow seamlessly across provincial borders to wherever the highest return is to be found.[7]

What follows is that higher Manitoban saving will cause higher Manitoban investment only if channelled into institutions or savings vehicles that focus mainly on Manitoban investments.

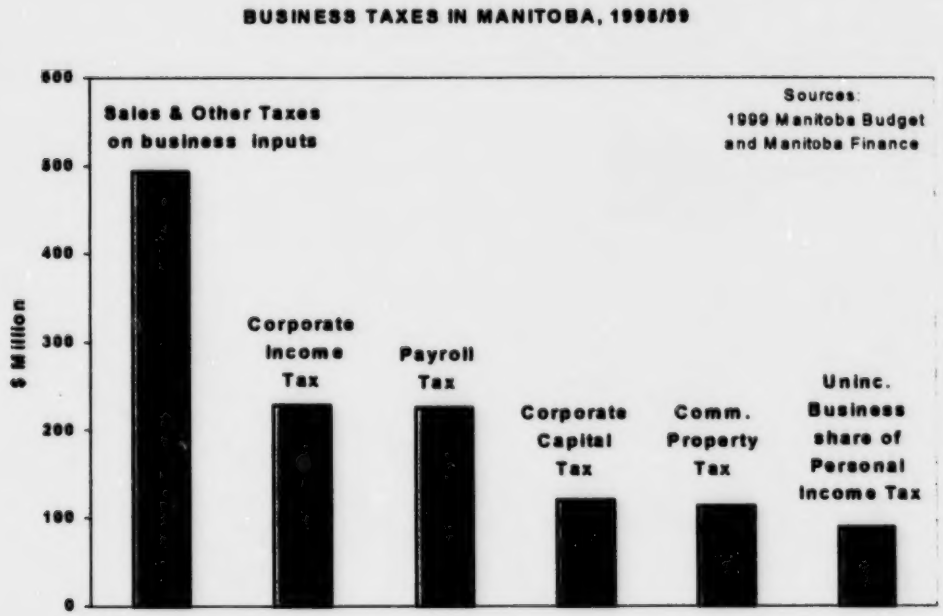
Summary (Consumption Taxes):

Consumption taxes are relatively fair, relatively simple, and do not seem to cost much in extra competitiveness.

[7] John Helliwell, *Do National Borders Matter?* (Washington, Brookings, 1998), ch. 6.

D. Evaluation of Business Taxes

The chart below shows revenue derived from specific business taxes, including an estimate of personal income tax resulting from the profits of unincorporated businesses. Business taxes are clearly far more than just the corporate income tax. Taxes applied to



business inputs and activities seem to be of greater importance than corporate income tax applied to profits. Each major type of tax is explained in more detail in *Section 10.*

1. Fairness:

The key to understanding fairness in the business tax field is to distinguish between the part of any tax that business owners can pass on (to customers, or employees usually), and the part that they must absorb out of their profits. Business taxes are passed on fully to customers or employees whenever the taxed firms can do so, which is whenever all rivals either pay the same tax or have other, equivalent costs. The part of any extra tax borne by firm owners in reduced profits is the amount by which that tax pushes their costs above the costs of rivals in their market.

It is a good first approximation to think of business taxes as being mostly passed on to customers, which makes them a form of consumption tax. Fairness of such taxes hinges on whether the customers bear these extra consumption taxes in proportion to ability to pay. We have a general sense that the poor tend to pay proportionately more of these costs than the rich because taxes on business inputs are built into the costs of all products, including food, shelter, medicine and children's clothing, that are exempt from the PST. Further, we have no reason to assume that the allocation of business taxes across

customers is at all fair, which makes this form of indirect consumption tax less fair than the explicit consumption taxes already discussed.

Depending on the sector, some portion of business taxes will be absorbed by firms in lower profits, but this allocation is not fairly distributed either. The more competitive the market, and the larger the market share of foreign rivals, the more of any business tax the firm must absorb. Prairie crop farmers are the extreme case of such firms, supplying almost entirely to world markets dominated by foreign producers. At the opposite end are most of the retail stores of the province. There is nothing fair about business taxes being absorbed most by our exporting firms and least by those in sheltered internal markets.

Manitoba's business taxes are unfair in another way- we rely more than most other provinces on taxes that are not tied to business profit. That is, the government(s) collects most of its business taxes whether the business has profit or not. In part this is due to the Provincial Sales Tax being levied on so many business inputs. Such profit-insensitive taxes increase the risk faced by Manitoba firms relative to rivals elsewhere, and do so unequally across sectors of the economy.

Some of the inequality is due to explicit policy choices that may be fair. For instance, small firms are exempt from payroll and capital taxes. The unfair, unequal outcomes result from some firms being able to pass more or less of the tax on to customers or even back to employees.

2. Simplicity:

Business taxes on payroll, sales, commercial property, and capital are generally fairly simple to understand and easy to collect. The tax base is straightforward, the rate of taxation is a simple flat rate in most cases. The corporate income tax is less straightforward, and in particular, its integration with the personal income tax is not widely understood. From a simplicity point of view alone, it is fortunate that corporate income taxes are a relatively small part of total business taxes.

If there is a significant cost saving to be had from having a single agency collecting both GST and PST, then the province should be moving towards harmonizing the two taxes. This decision will require Manitoba to rely less on levying the PST on business inputs.

3. Competitiveness:

The main objection to the application of business taxes is usually that they cause large distortions, big losses of competitiveness, and eventually significant migration of employers and the jobs they create. Objectors usually point to the total business tax revenue paid, without asking how much of it is passed on to customers in higher prices or to employees in lower wages. The presentation by the Canadian Bankers Association, by contrast, explicitly identified the consequence of our bank capital tax as another 13 basis points (0.13%) added onto loan rates; the banks planned to pass their taxes on to their patrons.

It is unquestionable that any extra tax absorbed by firms in lower profit lowers their competitiveness. As well, any extra tax absorbed by the firm's employees in the form of lower wages lowers the firm's competitiveness, in that it will be more difficult for the firm to attract and to keep labor.

Only if the tax raises their total operating costs above those of out of province rivals, however, is it likely to cause their market share to fall, and it is loss of market share that causes firms to shut down and lay off their employees in Manitoba.

Business taxes on specific types of input such as labor or capital will cause firms to shift to other inputs instead, where their technology allows such substitution. Fortunately or otherwise, business taxes in Manitoba are applied to labor and capital explicitly in payroll and property and capital taxes, and the PST is applied to almost all business inputs. The net distortions towards or away from labor or invested capital are likely to be small.

There is a strong case to be made for removing or reducing the payroll tax. First, we want to encourage in-migration to Manitoba, and we know that inter-provincial migration is reliably attracted by the presence of good job opportunities. Second, economists are increasingly telling us that the most important resource of any economy is its human capital - the more skilled people we attract and employ, the faster our productivity is likely to grow. The payroll tax raises revenue to government by raising the cost of employees to businesses, and in particular of the highly paid, skilled employees with the human capital we badly want. This causes firms to plan on hiring fewer of them. The last bias the province needs for the next two decades is one that causes firms to shrink their payrolls, if skilled people, and more of them are the source of extra productivity growth.

Summary (Business Taxes):

The burden of business taxes is unfairly distributed both across firms and across customers of taxed firms. Explicit consumption taxes are fairer in that we know better what burdens we are imposing, and then can offset the worst inequities by exemptions and tax credits.

Manitoba can simplify its tax collection by harmonizing the PST with the GST, and realizing the savings of a single sales tax administration. What stands in the way is the loss of revenue from the PST levied on business inputs in Manitoba, so the first step would be exempting business inputs from the PST.

Business taxes do have significant competitiveness impacts, to the extent that they raise domestic producers' costs above those of rivals out of province; it is the comparison of total costs that is important, and not comparison of individual taxes. The payroll tax stands out as the one most likely to interfere with the province's economic growth.

7. RECOMMENDATIONS FOR THE OVERALL TAX MIX

In the previous section we analyzed the fairness, simplicity, and competitiveness of each of the four fields of provincial tax. Our recommendations for changing the overall tax mix flow from this analysis. Readers who have skipped that section may want to read at least the summaries at the end of each part. In this section we present the more general recommendations that significantly affect the shares of each tax field in the overall tax mix. Following this, in the next sections we present the details of our general recommendations, that pertain specifically to each field, and other recommendations about each tax field that do not affect the overall tax mix significantly.

The general recommendations below are followed by an accounting of how those changes would affect provincial budgets under two possible views of Manitoba's future.

General Recommendations:

- That the tax system be made simpler by changing to the Tax on Income system, and in order to remove the net income tax and surtax and surtax reduction credits.
- That the tax system be made fairer by adjusting basic personal amounts to reflect more closely what non-discretionary consumption actually costs in Manitoba.
- That the tax system be made more competitive by *reducing* personal income tax rates.
- That the tax system be made fairer and simpler by removing both the provincial portion of the residential property tax, and the property tax credits on the income tax form that go with it.
- That the tax system be made simpler, fairer and more competitive, by moving away from sales taxes on business inputs, towards an ultimately harmonized sales tax system.
- That where the desired changes above exceed the amount of tax room available after paying the costs of public services government decides it must provide, consumption taxes be increased to make up the shortfall.
- Where the tax room will appear only gradually, consumption taxes be increased temporarily to bridge the gap.

To what degree these recommendations would change the tax mix depends on how far and how quickly we need to go to improve competitiveness in the future. How far we need to go depends largely on how completely Alberta and Ontario are able to fulfill their current intentions of slashing personal income taxes, and the extent to which tax gaps matter to migration flows between provinces.

Two models developed: Because there is substantial uncertainty on the degree of sensitivity of migration to tax changes, we consider two possible models in making our recommendations:

- Model 1 The Balanced Growth Model
- Model 2 The Reactive Growth Model

To assist the government with its decision-making, the Commission has offered some criteria to consider in determining which Model to choose and how soon, depending upon how the world around us unfolds over the next few years. Alternatively, the two models can be looked upon as a two-stage process of tax reform. Model 1 would be a recommended minimum starting point, that bridges the way to move to Model 2 as soon as possible in light of the anticipated mounting tax competition.

Model 2 has a significantly greater immediate revenue impact on the province than does Model 1, given the present number and distribution of Manitoba taxpayers. That does not mean, necessarily, that Model 1 will be cheaper to implement than Model 2, and that a government finding itself short of excess revenue should choose Model 1 for that reason. Model 1 may actually result in a greater long run revenue loss to the province than Model 2, if it results in many current Manitobans choosing to migrate to other jurisdictions. If the choice of Model 1 over Model 2 leads to an additional 1,800 taxpayers leaving each year, then the additional cost of Model 1 after 10 years will be $50m per year in terms of the foregone taxes of people no longer here.

Model 1 The Balanced Growth Model . Alberta may soon have a single income tax rate of 11% and Ontario is aiming for a marginal income tax rate for middle income levels of 9%. Even if these two provinces do not manage to lower their tax rates to these levels, there would be excessive out-migration from Manitoba if our tax rates stay at current levels. In Model 1, we assume that each one percentage point difference in marginal personal tax rates causes 300 extra people to leave for Alberta and Ontario (See *Appendix C* for the data behind this rough estimate). To keep such out-migration down to tolerable levels, the province would have to lower its own tax rates to within 2 or 3 percentage points of those in Alberta and Ontario.

Manitoba will be even less competitive than it is at present if it decides to maintain such a large tax gap. More Manitobans will migrate elsewhere, but the government might feel that the loss of competitiveness is warranted, if the alternative is to cut necessary or urgently required spending. Our recommendations for Model 1 assume the provincial government has enough flexibility to keep a tax gap as large as 2-3 percentage points without excessive out-migration.

- **Effects on provincial revenues, relative to 1999-2000:**

1. Changing the personal income tax from Tax on Federal Tax to a Tax on Income does not by itself have any net effect on revenue, as the tax rates and credits can be adjusted to produce the same revenue as before.

Cost: **$0m.**

2. Changing the Tax on Income to have (a) fairer basic exemptions of $11,000 for a single individual, $15,400 for two, and $3,300 for each extra child, and then (b) more competitive marginal income tax rates of 14% up to a level of $150,000, and 17% thereafter, and (c) a competitive tax credit to reduce marginal rates still further for new skilled employees who work in Manitoba in the first four years after graduation (to replace the Learning Tax Credit).

Cost: **$210m.**

3. Improving fairness by:

(a) removing the provincial Education Support Levy from residences

(b) removing the property and rental tax credits associated with it, and

(c) supplementing the 55 Plus program to compensate those low-income elderly who would on balance lose from removal of both property tax and property tax credits. The net cost of all three is close to zero.

Cost: **$0m.**

4. Improving competitiveness and fairness and eventually improving simplicity by moving away from sales taxes on business inputs. This would cost about $360 m. if done by itself, or $100 m. if done together with broadening the base to include services. We should start by exempting business spending on production machinery.

Cost: **$50m.**

5. Reducing the marginal rate of the payroll tax for businesses having payrolls of between $1 and 4 m.

Cost: **$10m.**

Total cost: **$270m.**

6. As we have explained previously in *Section 5*, tax room of at least $300 m. will gradually open up because taxable activities are expected to grow while debt service payments will not. If most of that tax room is eaten up instead by rising health care or education costs, the province can raise the necessary revenues through extra consumption taxes. A one-point increase in Provincial Sales Tax raises an extra $130m. Half as much again can be raised by matching increases in excise tax rates on alcohol, tobacco, and gambling.

Offsetting revenue: **($190m)**

Tax room required: **$80m.**

The Commission would prefer to be recommending lower personal income tax rates of 13.5% and 16.5% for the circumstances of Model 1, and we would probably have done so had we reported several months ago. However, we have been led to believe that our earlier assumption of the provincial budget being basically in balance is already in question. Because of that uncertainty we have raised the recommended tax rate by 0.5%. in order to raise an extra $50m. of revenue and pare down the tax room required.

Model 2: Reactive Growth Model. If migration flows are over twice as sensitive to tax differences as we assumed for Model 1 (as in the pessimistic, worst case scenario discussed in *Appendix C*), or if the out-migration is predominantly amongst those groups vital to Manitoba's economic growth (entrepreneurs or skilled employees), then Manitoba will have to lower its marginal tax rates more to stay competitive.

The alternative would be large-scale out-migration that would undermine the entire provincial economy just as large-scale out-migration to cities has undermined the economy of countless small towns in North America. Such out-migration leads to a downward spiral of departures, shrinking income and spending and property values, rising tax rates on the shrinking tax base, followed by more departures, and so on.

One might plausibly assume that the federal government would renegotiate the Equalization arrangements with the provinces to prevent the damage such large interprovincial migration flows would cause to the nation. However, we have not assumed that there would be any such increase in federal transfers to support provinces like Manitoba against tax competition from Alberta and Ontario.

Our suggestions for achieving the General Recommendations under Model 2 assume the provincial government is constrained to lower the marginal tax rate to a flat rate of 11%, but is free to change some less visible parts of the tax system to recoup some of the lost revenue.

- **Effects on provincial revenues, relative to 1999-2000:**

  1. Changing the personal income tax from Tax on Federal Tax to a Tax on Income does not by itself have any net effect on revenue, as the tax rates and credits can be adjusted to produce the same revenue as before.

  Cost: **$0m.**

  2. Changing the Tax on Income to have fairer exemptions as in Model 1, lowering the marginal personal income tax rate to 11 % at all income levels above the basic exemption amounts, removing the Learning Tax Credit, but not providing any extra tax credit for the first four years after graduation.

  Cost: **$485m.**

  3. Improving fairness by:

  (a) removing the provincial ESL from residences

  (b) removing the property and rental tax credits associated with it, and

  (c) supplementing the 55 Plus program to compensate those low-income elderly who would on balance lose from removal of both property tax and property tax credits. The net cost of all three is close to zero.

  Cost: **$0m.**

4. Improving competitiveness and fairness and eventually improving simplicity by moving away from sales taxes on business inputs. This would cost $360 m. if adjusted by itself, or $100 m. if adjusted together with broadening the base to include services. We should start by exempting business spending on production machinery.

Cost: **$50m.**

5. Reducing the marginal rate of the payroll tax for businesses having payrolls of between $1 and 4 m.

Cost: **$10m.**

6. Shifting more of the tax burden onto consumption taxes. One point of the Provincial Sales Tax yields $130m. Matching increases in the taxes on alcohol. tobacco and gambling would raise that by half again.

Revenue recovery: **($190m)**

Remaining shortfall: **$355m**

- **Options available to finance the remaining shortfall:**

7. The province could raise $100m in revenue from the property tax by removing the property tax credit but leaving the residential part of the provincial property tax in place. While this change would not affect migration flows significantly, it would greatly increase the perceived unfairness of a tax already objected to on those grounds, so we do not recommend it.

Revenue recovery: **$0m**

8. The province could raise business taxes of some sort. We reject raising corporate income taxes under this scenario for the same reason that personal income taxes are lowered to 11%. It is inconceivable that individual migration could be as tax-sensitive as assumed in this scenario, without corporate migration being equally sensitive. Other business taxes could be raised instead, but there is a fairer and more competitive alternative. Where business taxes are passed on to customers and become a hidden consumption tax, it is fairer to raise consumption taxes explicitly. Where business taxes would instead be absorbed by firms with lower net incomes, causing large out-migration under the worst-case assumptions of this scenario, it will be more competitive to raise consumption taxes instead.

Revenue recovery: **$0m.**

9. The province could raise all consumption taxes except gasoline and motive fuel taxes by a further percentage point.

Revenue recovery: **($195m)**

Tax room required: **$160m**

- **Other alternatives if tax room is insufficient:**

If $160m of tax room is not available, there are only three other options for dealing with the remaining shortfall:

10. Finding extra efficiencies in government not yet found. **$0-160m**

11. Reducing government services of some sort (opening up a service gap instead of a tax gap). **$0-160m**

12. Recovering some of the foregone personal income tax revenue without raising marginal tax rates, by imposing the same kind of flat-rate health care premium as in Alberta and Ontario. It is plausible that migration flows are much less sensitive to less visible parts of the tax system, and the health care premiums of Alberta, British Columbia, and Ontario are certainly less visible. To hide the $160 m. shortfall above would require a premium to be set at nearly $400 per adult, if one assumes that those below $25,000 of income would be exempt. **$0-160m**

13. Increasing tax or dividend payments from Manitoba Hydro and Manitoba Public Insurance Corporation. **$0-40m**

Budgeting Procedure: Every government needs to budget prudently, according to the laws of the day. In fact, the budget process itself may require revisiting: rather than setting expenditure levels first, it would seem more prudent to look at revenues raised and then set expenditures appropriately. If we are prudent in our spending over the long term, we may not have to pay down the debt as quickly as would otherwise be needed.

Recommendation # 3:

The Commission recommends that government adopt a budgeting process similar to that used by many businesses, where tax rates are set and revenues are estimated first, and then expenses are constrained to fit estimated revenues.

Implementation of Recommendations.

Recommendation # 4:

The Commission recommends that the government implement the recommendations contained in this report by the Year 2002 and to consider a <u>temporary</u> increase in the PST to fund provisions that will be financed later out of growing tax room.

8. RECOMMENDATIONS FOR THE PERSONAL INCOME TAX

Personal Income Taxes in Manitoba Today: For the year 2000, basic provincial income tax rate is 47% of Basic Federal Tax, before surtaxes. In addition there is a 2% flat tax on all net income, and a 2% surtax on net income above $30,000. There are also targeted tax reduction credits to shelter incomes from tax, in amounts that reflect individual circumstances such as income, number of dependants claimed, age, and disability.

Further tax shelter is provided by several refundable tax credits. The Cost of Living Tax Credit varies with the same features as the tax reduction credits above, and is clawed back at higher income levels. The Property Tax Credit shelters homeowners and renters from part of their residential property taxes, in amounts which are tied partly to age, and clawed back to the minimum of $250 at higher income levels. The Learning Tax Credit shelters income used for post-secondary education, without claw-back. The Political Contribution Tax Credit and the Labor-Sponsored Funds Tax Credit shelter income used for those purposes.

The tax credits above are on top of the long list of federal tax credits that shelter income used for CPP contributions, Employment Insurance payments, child care expenses, RRSP and RPP contributions, charitable donations, medical expenses, tuition and student loan interest costs, labor-sponsored fund investments, and so on.

Manitoba redistributes much more income via tax credits than other provinces outside Quebec. In 1997, for instance, Manitoba's provincial tax credits and rebates per head were $114, Ontario's were $91 and the nearest province after that was British Columbia at $13.

The New Tax on Income System: As we mentioned in the Preamble, the provincial government has already given notice to the federal government of its intent to move to the new Tax on Income system as soon as possible. **We commend the government for this decision.**

The Tax on Income system will simplify the way personal income taxes are calculated by allowing Manitoba to abolish the net income tax and surtax. It will improve transparency and help taxpayers identify more readily the taxes imposed by each order of government. It will allow us to keep the efficiencies provided by the federal-provincial Tax Collection Agreement, with its common tax base and common rules in all participating provinces and territories. Further explanation of the Tax on Income arrangements are to be found in *Appendix A*.

All of the Commission's recommendations in this section presume the province is operating under the new Tax on Income system, with all of its flexibilities and constraints. The flexibilities refer to the structure of the marginal tax rates and any additional tax credits desired by the province. The constraints ensure that Manitoba will accept the federal definition of taxable income, and all of the federal income tax credits in number and value.

Design of the Tax on Income System

The Commission begins with some premises that follow from *Section 5 The Context for Tax Reform*, and the three criteria given in our terms of reference.

Basic Premises:

1. Manitoba's comparative advantage does not appear to lie in any particular sector which the government can enhance with specific tax credits. The fact that Manitoba has such a diversified economy, without a single dominant sector, suggests that Manitoba's entrepreneurs are Manitoba's comparative advantage, and they can find success across almost all sectors if given the opportunity.

Recommendation # 5:

The Commission therefore recommends for Manitoba a neutral non-distorting tax system in which businesses and investors face roughly the same tax burden regardless of their sector of the economy.

2. Income redistribution, to help those who cannot earn taxable income, can be more effective through explicit cash transfers than through refundable tax credits under the income tax system. Explicit transfer programs include the province's Child-Related Income Support Payments, 55 Plus, and providing benefits in kind such as for health care and education.

   There are five reasons for believing that income redistribution is not best delivered through the income tax system:

   - Income-tested tax credits add complexity to income tax calculations.
   - All income-tested tax preferences imply clawback calculations as the tax preference is reduced by extra income. Clawbacks result in higher marginal tax rates over the income range in which the preference is clawed back, which can to some extent reduce work effort and encourage out-migration.
   - Support received through tax credits is not received on a timely basis (i.e. usually a year after the family starts earning qualifying income levels).
   - Tax preferences are much less transparent than the alternatives: explicit cash transfers and service delivery costs like health care and education are an obvious part of the annual budgeting system, so they are subject to regular annual scrutiny, while tax preferences are not.
   - Where the intended beneficiaries are children (particularly of low income families) service delivery programs provide some assurance that the assistance is going to those intended, rather than to their parents.

Recommendation # 6:

The Commission recommends that, where possible, methods other than the income tax system be used to redistribute income to needy families in Manitoba.

We discuss the main features of the new Tax on Income system in this order: first the basic personal tax credits that determine the income sheltered from tax for a normal household, then the structure of income tax rates on remaining taxable income, then the other non refundable tax credits, followed by the refundable tax credits, and finally indexing of tax credits.

The basic personal tax credits are discussed first and separately from the other non-refundable tax credits because they have the effect of creating a zero-tax bracket for every household, for the first amounts of income earned. It is useful to think of the basic tax credit amounts as though they set the threshold at which the regular income tax rates start to bite.

Allowing for the Basic Necessities of Life:

Fairness demands that we not tax those without ability to pay. Having ability to pay means, for income tax purposes, having more than enough income to afford the minimum or non-discretionary consumption spending necessary to participate in our society.

Recommendation # 7:

The Commission therefore recommends that earned income be sheltered from income tax by a tax credit until income exceeds non-discretionary consumption needs.

Our recommendations require the estimation of non-discretionary consumption needs. In order to do so properly, we have adopted the approach of the Federal-Provincial-Territorial Working Group on Social Development Research and Information.[8]

The Working Group determined what should go into the "market basket" to be bought as non-discretionary consumption. The cost of those items in Manitoba has been estimated from the cost data in Manitoba Agriculture's *Budget Guides*, prepared each year by the Home Economics Directorate. The process and numbers are presented more fully in *Appendix E*.

[8] *Construction of a Preliminary Market Basket Measure of Poverty* (Ottawa: Mimeo,1998).

Our estimate of the cost of non-discretionary consumption for a family of four, for 2000, is $22,000. To convert this to amounts for each individual we have used the generally accepted, widely used scales for the extra costs of each additional family member, relative to the costs of a single individual. The scale is as follows:

Non-discretionary needs of the first adult of either sex:	100%
Costs of extra needs for each extra adult:	40%
Costs of extra needs for the first child to a single parent	40%
Costs of extra needs for each extra child	30%

When a family of four has total costs of $22,000, the proportions above imply that the cost of non-discretionary consumption for a single individual is $11,000, the extra costs of a second adult or a first child in a single-parent family is $4,400 (40% of $11,000), and the extra cost of each extra child is $3,300. Income up to these amounts should somehow be sheltered from income tax.

To shelter non-discretionary income properly for households of different sizes, we would need to have basic tax credit amounts of $11,000 for a single adult, $15,400 when a spouse or spousal equivalent is added, and $3,300 more for each subsequent child, as we recommended under both models in *Section 7*.

Reconciliation with the federal income tax system: We cannot shelter non-discretionary income properly by creating a basic tax credit amount of $11,000 for the first adult and then $4,400 for a dependent spouse or spouse equivalent (a first child to a single parent), for two reasons.

- Provincial amounts for tax credits that the federal government also uses must be at least equal to the federal amounts, under the new Tax on Income rules. The federal tax credit amounts are $7,131 for the first adult, $6,055 for a dependent spouse or spouse equivalent, and $0 for each extra child. Manitoba cannot reduce the spousal exemption amount below $6,055.
- The fact that the personal income tax is still based on the individual rather than the family means that all two-income households would report both incomes separately and claim basic allowances of $11,000 each, or $22,000 in total. This is $6,600 too much tax shelter for two-income households relative to the rest. Such extra tax shelter has been contentious in the past, when the amount of extra tax shelter was far less than $6,600.

Both problems can be solved if we provide:

- a basic tax credit amount of $7,700 for the taxpayer and spouse or equivalent, so the total amount for two-adult households would be $15,400 whether both adults work, or only one.
- a supplemental tax credit amount of $3,300 for those taxpayers who are single, to bring their allowance up to $11,000, and
- $3,300 more for each subsequent child.

This solution raises all of the provincial equivalents to the federal tax credit amounts, which a province is free to do, and creates a new tax credit for children and one for single individuals. Families of all sizes can shelter the proper amount of income to reflect their non-discretionary consumption costs, regardless of whether or not the spouse works outside the home. The gain in fair treatment of families is substantial, the increase in complexity is small. Therefore,

Recommendation # 8:

We recommend that the basic provincial tax credit amounts be $7,700 each for the taxpayer and spouse or spousal equivalent, and $3,300 for each child, with a supplemental tax credit of $3,300 for all taxpayers living without spouse or equivalent.

Federal Tax Credit Amounts: It is unfortunate that the federal amounts do not shelter sufficient income from federal tax, both for single individuals and for single-income families with children, with the result that these households will pay federal tax on some income needed for non-discretionary consumption.

Necessary employment expenses are also a form of non-discretionary spending for those who decide to work, and should be allowed as well. Currently this is only partially recognized with allowable employment expense deductions used in calculating taxable income, and this is outside the province's control even under the new Tax on Income system. The federal employment expense deduction is too restrictive with regard to actual costs for employees both absolutely and relative to the self-employed, so employees end up paying tax on some income needed to offset employment expenses.

Recommendation # 9:

We recommend that the provincial government urge the federal government to adjust its basic tax credit amounts in line with the costs of non-discretionary consumption for households of different types, and to increase its employment expense deduction to reflect better the true costs of employment.

Income Tax Rates:

We have already evaluated the fairness, simplicity, and competitiveness of Manitoba's personal income tax system in *Section 6* above.

Simplicity will be greatly improved as soon as a tax on income system is adopted in 2001, because it will also mean removing the Net Income Tax, the Net Income Surtax, the Manitoba Tax Reduction and the Surtax Reduction that are all part of the current Tax on Tax system .

Fairness will be improved by the changes we recommended earlier in basic allowances, especially for low-income households. We will no longer be collecting as much tax from those without ability to pay. The changes have the largest proportional impact on the tax burdens of relatively low-income households; it takes many off the tax rolls altogether, and the working poor will be able to earn more before being subject to taxes.

Fairness will be improved across all income groups by moving closer to the principle of taxing according to ability to pay, which we have adopted as our standard of vertical fairness. If tax paid should rise proportionally with ability to pay, which the Commission believes reasonable, then the province should not have a set of marginal tax rates that rise steeply with taxable income. A tax that rises proportionally to ability to pay implies a one-rate system or something close to it, like the simple one-rate structure we have for consumption taxes.

Such a system will still produce steadily rising average tax rates, because of the large initial income range that is sheltered from any tax by the basic allowances or other tax credits, and it is rising average tax rates that everyone insists on as a minimum condition for vertical fairness. The chart in *Section 6* shows that both the current system and a one rate tax system both produce significantly rising average tax rates across income levels.

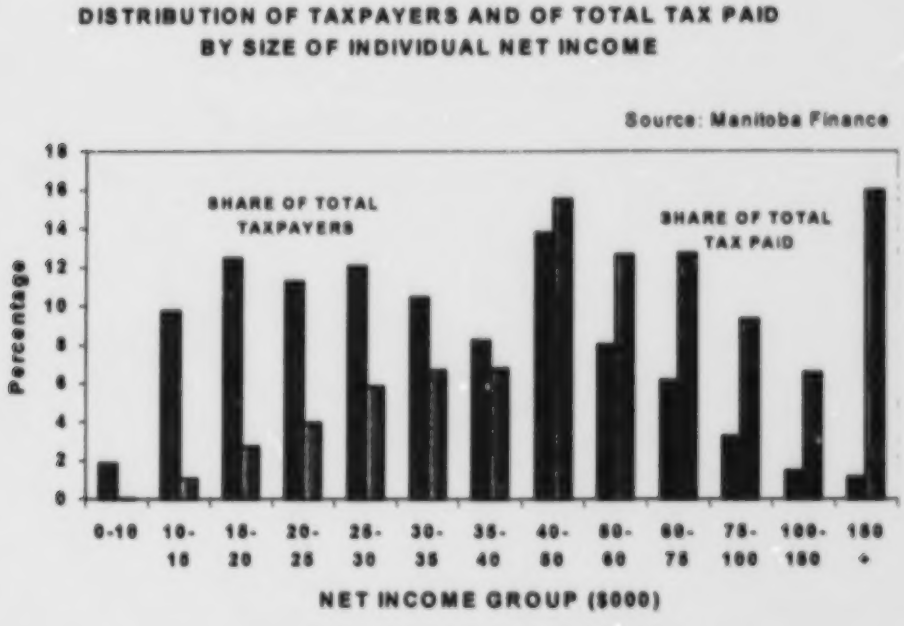
Average tax rates rise very slowly at higher income levels under a one-rate system, however. To many Manitobans the rise would not be fast enough to be fair. In the circumstances of Model 1, where the province can afford to have higher rates than neighbouring provinces, we therefore keep some progressivity in marginal rates, but with only one step of three percentage points (from 14% to 17%), and that only applied to income above $150,000. In 1998, 1% of all taxpayers had income that would have been taxed at this top rate. In 1998, the top marginal rate kicked in at $60,000.

For the circumstances of Model 2, where far more than just the young and skilled will migrate if taxes are out of line, we do not think the province can afford the higher tax rate even above $150,000; too many would leave, and too many of the out-migrants would be the province's job-creating entrepreneurs.

What about competitiveness?

The part of the income tax rate structure that matters most to competitiveness is in the income range between $40,000 and $100,000, that being the most relevant to the skilled young workers who account for the bulk of inter-provincial migration. For competitiveness, we would like to be able to lower marginal tax rates substantially in this range. Unfortunately, as the chart that follows shows, this income range includes one third of total taxpayers, and half of total income tax revenue. Any reduction in the tax rate of this group means a major loss of revenue from personal income tax.

Any income tax preference aimed specifically at relatively skilled young workers will



therefore be less expensive if it is targeted more narrowly than at all income earners in the income range from $40,000 to $100,000. For the circumstances of Model 1, or as an interim measure toward Model 2, we therefore try to lower marginal tax rates very significantly for just a narrow but most critical group, with a targeted Post-Secondary Graduation Tax Credit that is discussed below. For other middle income earners, we keep a rate closer to those of rival provinces than we have now, but not as competitive as for the target group..

Under the circumstances of Model 2, the province cannot afford to have personal income tax rates out of line for people of any age, so marginal tax rates must be low for all. There is no targeted tax credit because none is needed if the basic rate is already low. The down side of Model 2 is that the province foregoes much more income tax revenue, as shown in *Section 7*, and that shortfall must be made up somewhere else.

We balance fairness, simplicity and competitiveness in the different circumstances of Models 1 and 2 with two formal recommendations for income tax rates.

Recommendation # 10:

We recommend that either under the circumstances of Model 1, or as an interim measure toward Model 2, the government set an income tax rate of 14% for all non-sheltered taxable income up to $150,000, and 17% thereafter.

Under Model 2, where the government must be much more concerned about migration flows of all groups, the province cannot afford even the mild progressivity of marginal tax rates in the proposal above.

Recommendation # 11:

We recommend that under the circumstances of Model 2, the government set an income tax rate of 11% for all non-sheltered taxable income.

Other Non-Refundable Tax Credits:

The Commission's preferences on non-refundable tax credits are the following:

- For fairness, we prefer that the credits shelter income that must be used for non-discretionary consumption.
- For simplicity, we prefer that the province merely use the federal credit calculation structure as is, so that no separate tax forms are required to calculate provincial tax credits.
- For competitiveness, we prefer that the credits be targeted to those individuals most likely to react to inter-provincial differences in income and targeted at the decisions most important to Manitoba's future growth.

Post-secondary Graduation Tax Credit: One of the major benefits to be achieved by reform of the income tax system is to improve competitiveness. To improve competitiveness requires lowering marginal tax rates on the middle range of taxable incomes, since that is where one finds those young skilled employees who are most vital to competitiveness and most likely to migrate elsewhere.

Changing from progressive to flat marginal tax rates, however, will do little for those in the middle income range, under Model 1. Only a drastic lowering of all rates will directly benefit middle-income-earners, and that would require very large increases in other taxes.

Therefore in Model 1 we recommended that the province adopt a marginal income tax rate of 14% for the income range from the end of the sheltered amounts to $150,000. However, we recognize that this by itself will not make Manitoba sufficiently tax competitive for young skilled employees.

What will make Manitoba more competitive for young skilled employees is a highly visible tax preference aimed specifically at the most mobile segment of the labor force: those just graduated from their program of post-secondary training. It seems plausible that once graduates take up a post in Manitoba for even a few years, it is more likely that they will stay in the province thereafter.

For the credit to be highly visible, it must directly affect the most visible part of the income tax system - the marginal tax rate. We therefore tie the amount of a new credit directly to the amount of provincial tax payable.

Recommendation # 12:
We recommend that the government add to the Tax on Income system a Post-Secondary Graduation Tax Credit with the following features:

- **equal to half of provincial tax payable;**
- **available only for the four tax years following graduation from a post-secondary program of two years or more;**
- **available for programs completed in Manitoba or elsewhere;**
- **electable only once, for graduation from one program;**
- **capped at $5,000 per year.**

We estimate that this tax credit would cost about $28 m. per year, roughly twice the Learning Tax Credit.

Labor-Sponsored Funds Credit: Investment in new physical capital is always important to growth of living standards: increasing capital investment can dramatically increase the productivity of individuals who work in the business. If we succeed in attracting the skilled employees that Manitoba firms told us they need, employers will need to invest in new processes, equipment and training for those employees on an ongoing basis as new technology and knowledge levels face rapid obsolescence.

However, it is also clear that most saving in Manitoba flows right into a national capital market in which Manitoba firms may even have a disadvantage relative to firms from larger provinces. The research evidence supports the idea that raising savings rates in British Columbia, for instance, has little or no effect on investment in BC, though it will raise investment overall in Canada. [9]

It follows that general tax incentives to save will do little for investment in Manitoba. Any tax credit designed to promote investment specifically in Manitoba must be more narrowly targeted, directing savings into financial assets that are somehow tied to investment in Manitoba. Units in Labor-Sponsored venture capital funds are just that sort of financial asset. Shares of Manitoba-based firms, traded on the Winnipeg Stock Exchange, are another.

Labor-Sponsored venture capital funds also provide significant political benefits, as they represent important collaboration between the government, business, and labor groups in the province. Such collaboration makes societies function more smoothly.

Recommendation # 13:

We recommend that the Labor-Sponsored Funds credit and the new Manitoba Equity Tax Credit be continued in their current form.

[9] John Helliwell, *Do National Borders Matter?* (Washington: Brookings, 1998), ch. 6

Refundable Tax Credits:

Cost of Living Tax Credit: The obvious justification for this income-tested, refundable tax credit is as an offset for consumption taxes that would otherwise be payable on non-discretionary consumption. That is, it plays the same role for the Provincial Sales Tax that the federal GST Credit plays for the GST.

In Manitoba, food, shelter and children's clothing are already exempt from provincial sales tax. The PST would still be unacceptably large for low-income groups if it were not for this tax credit.

Our estimate from the information in Manitoba Agriculture's Budget Guides 1999 is that PST accounts for just under 2% of the non-discretionary consumption levels identified earlier under Basic Exemption Amounts. Also, all households that use automobiles for transportation pay approximately $100 of excise tax on gasoline. These costs would total nearly $290 for the basic allowance, $80 for a dependent spouse or equivalent, and $60 for each extra child. This is almost the same as the current Cost of Living Tax Credit amounts of $190, $190, and $25.

The Finance or Agriculture Departments could perform more continual and accurate measurements than we have done to estimate the actual consumption tax charged on non-discretionary consumption of families of different sizes and circumstances. This should be reflected in the actual amounts assigned to this credit. The purpose of the credit itself would be clearer if its name was changed to refer explicitly to the PST it is designed to accompany.

Recommendation # 14:

We recommend that the Cost of Living Tax Credit be renamed the Provincial Sales Tax Credit, and set at levels that reflect consumption taxes paid on non-discretionary consumption.

Property Tax Credits: The various property tax credits currently appearing within the income tax forms are designed mainly to soften the worst inequities of the Education Support Levy on residential property. These include the Property Tax Credit, Resident Homeowner's Tax Assistance, and Homeowner's School Tax Assistance. Full details on this issue will be found in *Section 9*.

Learning Tax Credit: There is already a federal tuition and education amount tax credit, and one for interest on student loans, that subsidize post-secondary education in Canada.

Provinces of course pay most of the costs of post-secondary institutions, so tuition is already greatly subsidized by provincial taxpayers. However, education tax preferences at the provincial level should be targeted to meet specific provincial social and economic policy objectives.

We have therefore suggested a new tax credit for Model 1 and a much lower tax rate for Model 2, that will motivate students to acquire post-secondary training by increasing their after-tax benefits after graduation.

Recommendation # 15:

We recommend that the province terminate the Learning Tax Credit.

Indexing: Much ink has been spilled over the idea that tax brackets and credit levels have been shrinking in real terms over the last several years because they are indexed only for inflation above 3%. This amounts to a hidden tax increase. It is unfair whenever basic exemption amounts fall below what is needed to pay for non-discretionary consumption.

However, it is not appropriate to over-index tax credits. It is well known that annual changes in the Consumer Price Index are an upward-biased measure of increases in the true cost of living, for two reasons in particular:

(1) omitting new products from the consumer expenditure basket (it is new products whose prices usually fall most rapidly), and

(2) not allowing for consumers shifting their spending away from goods whose prices have increased most.

Estimates of the bias center around 1.0%.

If the provincial government were to allow the credit amounts to rise an extra 1% each year over the true increase in the cost of living, it would forego an *extra* $15 m. of income tax revenue each year. That means foregoing $150 m. per year of income tax revenue by the end of ten years, with no justification (and no political credit).

While it is possible that other governments will change to index their tax credit amounts and brackets to the inflation rate of the Consumer Price Index as though that measure had no bias, indexing to changes in the Consumer Price Index less 1% will not lower our competitiveness at all, as this is not a detail that anyone takes into account in migration decisions.

Nor will it increase complexity. Choosing to index adds complexity to the tax system, but choosing to index at a 1% lower rate does not change complexity at all.

Recommendation # 16:

The Commission therefore recommends that the government index the tax credit amounts and brackets to increases in the cost of living, measured as the inflation rate of the Consumer Price Index less 1%.

9. PROPERTY TAX REFORMS

In *Section 6* we discussed property taxes in two parts: the part levied on residential property, and the part levied on commercial property. The latter is a form of capital tax on business firms, and was discussed along with all other taxes on business firms. We continue that distinction and discuss in this section only residential property taxes, leaving commercial property taxes to *Section 10*.

One possible misunderstanding should be laid to rest right at the start. It is not the Commission's mandate to consider the spending side of the provincial budget. We therefore assume that the total sum the province distributes across school boards ($779 m. for the past year) will continue independently of any changes made to the Education Support Levy. All that will change will be the portion financed out of general revenues as opposed to Education Support Levy. In other words, in proposing changes in this particular tax we are not implicitly recommending a matching change in educational grants to school boards.

Unfairness of property tax burdens:
The dominant fact regarding residential property taxes is that they give rise to the most and the loudest complaints, at least from the presenters to the Commission. Some of these complaints excluded municipal taxes, which many see as justified by the benefit principle as many taxpayers do see a link between their taxes and the local municipal services provided to them. Education tax levels caused the vast majority of complaints made to the Commission.

Almost all of the complaints concern unfairness of some sort. We have explained briefly in *Section 6* that residential property taxes are reasonably fair if seen as a form of consumption tax on shelter spending, if we ignore some large anomalies in assessment levels across properties, and if we compensate for inequities through direct payments to low income earners. However, few ratepayers see property taxes that way. Most taxpayers view the property tax either as a form of wealth tax, or as a user fee for general education that everyone is charged, whether users or not. We have explained in *Section 6* that from either of these viewpoints the residential property tax is grossly inadequate. Large differences in the timeliness of assessments and special treatment of condominiums, life-lease apartments and cottage leases in provincial parks, lower the fairness of this tax even more.

Resulting ratepayer resentment is deepened by the rapid increases in local school levies over the last decade, and by the fact that some of the taxpayers are not allowed even to vote in elections for the school boards that have imposed those increases.

The province is only one of three levels of government that use the property tax to raise revenue, and its part is probably the least unfair in that the mill rate is the same across the whole province. Residential property taxes are such a bone of contention, however, that even removing the fairest part of the property tax will make the provincial tax system as a whole seem fairer. Removing the provincial government from the residential property tax field will also make the remaining problems of the tax simpler and therefore easier for some future Property Tax or School Board Commission to address.

Recommendation # 17:

We therefore recommend that the residential portion of the provincial Education Support Levy be removed from property tax bills on residences and cottage properties.

Property tax credits:

We recognize the various property tax credits and exemptions - tax credits for homeowners and renters, exemptions for owners of life-lease apartments and provincially subsidized housing - as acknowledgments of the unfairness of taxing on the basis of the value of real estate, rather than on the basis of discretionary consumption.

These tax allowances address two different problems. First, the property tax makes no allowance for some housing being non-discretionary and therefore not a reflection of ability to pay. The flat-rate $250 Homeowner Tax Assistance is intended to shelter a minimum amount of housing cost and correct this unfairness. Second, property tax burdens are inequitable in taxing heavily a large group of low-income elderly owners and young homeowners. The Homeowners' School Tax Assistance and the rest of the regular property tax credit are both intended to correct some of this unfairness.

Both problems disappear when the province no longer applies its Education Support Levy to residential property. Municipalities and school boards will no doubt argue that both types of unfairness remain in their property taxes, and that the provincial tax credits in particular should be left in place for their sake. We see no reason why municipalities and school boards cannot make their own allowances for non-discretionary shelter costs and for low-income elderly taxpayers or young homeowners, although such allowances will make the remaining property tax system somewhat more complicated.

Recommendation # 18:

We therefore recommend that as it removes the residential portion of the Education Support Levy, the province also remove the system of property tax credits, including Homeowners' School Tax Assistance from its personal income tax system.

Offset adjustment:

Some individuals will lose more from the removal of the tax credits than they pay in Education Support Levy. These are typically elderly, low-income owners of low-value property. Many will be rural, since rural property values are typically lower than urban property values.

We do not intend that such individuals be victims of the changes recommended above. At the same time, we do not feel that a special tax credit should be kept in the provincial income tax to compensate just this narrow group of beneficiaries. Such a provision would not only violate our general prescription against tax preferences and in favor of

explicit transfer payments, but would add a disproportionate amount of complexity to the personal income tax form.

The province already has shelter allowance programs (Shelter Allowance For Elderly Renters, Shelter Allowance for Family Renters, and the 55 Plus program) that can be expanded to cover the special needs of the small groups disadvantaged by the changes above.

Recommendation # 19:

We therefore recommend that the province extend its existing shelter allowance programs to compensate those low-income or elderly homeowners or renters who would on balance lose from the changes in the previous recommendation.

Timing:

The property tax credits cost some $20 m. more than is collected through the residential portion of the Education Support Levy, so the first two recommendations would leave the government budget that much better positioned. Our third recommendation would use up all or most of this amount. Since the net change in provincial revenue is close to nil, there is no reason to phase in this set of changes slowly over many years. As a package, they do not need to wait for tax room to develop.

Recommendation # 20:

We therefore recommend that the changes to the property tax and related credits be implemented for 2002.

Transitional safeguard:

The purpose of the previous recommendations is to lower the total property tax. An opportunistic school board or municipality could see the withdrawal of the province from taxation of residential properties as a chance to increase their own mill rates. If timed right, their mill rate increases would not cause total property taxes to rise, and would therefore be less likely to be noticed by their ratepayers.

Such action would frustrate the main purpose of our recommendation: we want the fairness of the overall tax system improved by having total property taxes fall. There should be an interval of at least three years after the provincial tax is removed, during which municipal and school board mill rates stay unchanged and residential property tax bills will be lower by the provincial withdrawal. By the end of that interval taxpayers will have formed a new reference point for total property tax, and take appropriate notice of later mill rate changes by municipalities and school boards.

Recommendation # 21:

We therefore recommend that for the three years following removal of the residential portion of the Education Support Levy, the government impose a freeze on property taxes assessed by municipalities and school boards, with appropriate allowance for such changes as they may need to improve the fairness of their property tax systems.

Condominiums and Portioning:

In the minds of some of the presenters, the province is a party to one of the larger inequities of the property tax system by its legislation on what Portion of a residential property assessment should be subject to tax. Today, property tax payable is determined as the property value, multiplied by a Portion, multiplied by a mill rate. The Portions are set by the provincial government.

Condominiums were originally treated as apartments, with a Portion of 33%. Their Portion has been raised since 1992 and will reach the 45% Portion of detached homes in 2001. The increase in both Portion and school board mill rates have produced very large and in some cases insupportable property tax increases for many condo owners.

However, since we are recommending removal of the residential portion of the Education Support Levy, the Portioning will affect only municipal and school board revenue, which is outside our mandate.

Life-Lease Apartments:

A life-lease apartment is similar to a condo in most respects. There is a nominal landlord, as for an apartment, and the lease expires with the death of the lessor, but otherwise the life-lessor has all the rights of tenancy and sale of an owner. There are 49 buildings in Manitoba whose apartments have been converted officially to life-leases, with about 2,000 individual units.

What makes this form of tenancy relevant to this Commission is that under the Elderly and Infirm Persons Housing Act, the government licensed a group of non-profit developments with small life-lease apartments and made them exempt from provincial and local education taxes. This seemed appropriate because they were small and intended for low-income tenants who would otherwise have been eligible for the full property tax credits.

For a while some developments with larger apartments also managed to obtain these licenses, but that loophole has been closed. The remaining life leases, however, are more valuable because of their privileged tax treatment, and their higher market price must have been the source of much profit for the original developer.

What remains is that licensed life-tenants of small apartments are exempt from both provincial and school board property taxes, while similar owners of equally small housing space in other forms (condos or detached houses) pay both types of tax. The low-income condo and home-owners will receive rebates and credits for some or all of their property

tax and may themselves end up with little or no net education tax on their property. However, that is not at all transparent when the property tax credit is not received until tax is filed in the following spring, and not all owners of life leases have low income. This arrangement is therefore horizontally unfair.

Solutions: Our recommendation that the residential portion of the Education Support Levy be removed will reduce the disparity between life leases and condominiums by lowering total education taxes.

As far as their exemption from the local school taxes is concerned, our general recommendation would have tax preferences being converted into explicit cash transfers, like those in the province's existing shelter allowance programs. If that were done with life leases, then the only residential property owners that would be able to avoid school taxes would be those with low enough income to qualify for shelter assistance. Middle or higher-income individuals would not escape school taxes just because they were able to buy a tax-privileged apartment. Developers would not receive larger prices for their apartments because they were able to secure a government license to avoid schools taxes. Horizontal and vertical fairness would be restored, and would be seen to be restored.

Recommendation # 22:

We therefore recommend that the government no longer issue licenses that exempt life lease apartments from education taxes of any sort, that those licenses currently in place be revoked on a "suite-by-suite" basis upon the first turn-over of any suite, and that government instead provide any necessary support through the existing shelter allowance programs.

Cottages and provincial parks:

We heard from many cottagers, especially but not solely regarding school taxes. Many were upset at paying the Education Support Levy on two properties, and receiving only a single property tax credit. Others protested the assessment of their cottage, and their lack of a vote for the school boards that assessed their taxes.

If the residential property tax is essentially a tax on housing consumption, it is fairly clear that those who choose to own cottages are consuming much more shelter that those who live in just one property. Paying property tax on both city home and country cottage is no more unfair than a three-car household paying GST and PST on all three cars, or someone with two jobs paying income taxes on the earnings from both. A claim of inequity would have to be based on the property value assessments being inflated. We do not think ourselves capable of assessing value better than the marketplace, so we make no recommendation to address this complaint.

What is unfair is the exemption from school taxes of cottages located in provincial parks. This inequity cannot be justified under the ability to pay principle: cottagers with long term leases on land in provincial parks are just as able to pay as those outside. Nor can it be justified by the benefit principle, since education taxes are levied on all regardless of their use of the school system, and so are not to be evaluated by the benefit principle.

However, we have already recommended removal of the provincial tax for education. That removes the inequity as far as provincial taxes are concerned.

The only education tax left is the local school board levy. We can conceive of a special arrangement between Parks Manitoba and local school boards in which Parks Manitoba would pay an equivalent-to-school-tax to each adjacent school board and then pass it on to cottager lessees in each park, but this is an issue of school board rather than provincial government finance. As such it is outside our mandate and we make no recommendation.

Incentive for property improvement:

Property taxes do not cause significant out-migration of skilled employees or cause disincentives to work or to save. By themselves, they discourage spending on property improvement. Any improvement raises assessed property value, which subjects the taxpayer to an annual extra property tax of up to 2.5% - less if the spending is not all passed through to property value.

Any spending on property improvements to increase the value of a principal residence is also sheltered from the capital gains tax, so it is not clear that there is a net disincentive to property improvement for principal residences. There remains a net disincentive for rental properties, to the extent that the extra tax costs are not passed on to renters, since capital gains on rental properties are not exempt from income tax on liquidation.

For both types of property, our recommendation to remove the residential portion of the Education Support Levy will mean greater incentive to spend on improvements.

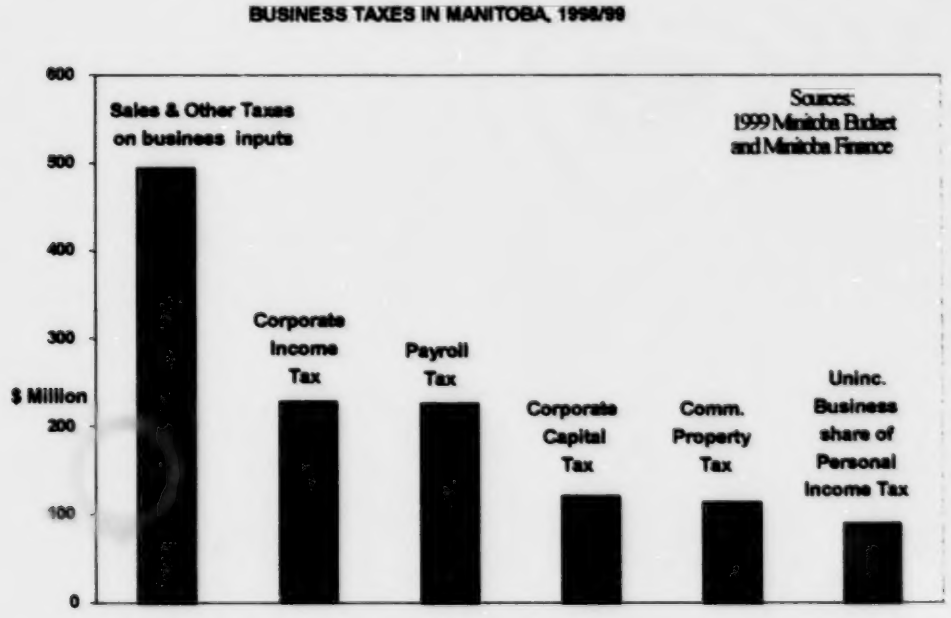
10. BUSINESS TAX REFORM

Current Business Taxes:

This category includes a variety of taxes. They are similar in that they are collected from business firms and assessed on the basis of some activity of that firm. For convenience we repeat the chart of business taxes from *Section 6*, which shows the six major types of tax.

Some of the taxes require a bit of explanation:

- Corporation income tax is levied at 7% on the first $200,000 of taxable income (for Canadian-controlled firms), and 17% thereafter, on top of federal taxes.
- The payroll tax is a flat 2.15% labor tax for large firms, but exempts smaller firms entirely. Firms under $1m of annual payroll pay no tax. Those between $1m and $2m pay 4.3% of their payrolls above $1m, while those above $2m pay a flat 2.15% of their total payroll.



- Capital taxes are assessed at 0.3% of capital (0.5% for larger firms), with a separate rate and definition of capital for banks.
- Commercial property taxes include only the commercial property part of the provincial Education Support Levy (not local business taxes or school or municipal taxes). This is levied at a uniform mill rate of just over 18 mills, but farmland is exempt.

- Sales and excise tax on business inputs is based on the government estimate that 40% of total PST revenue (that is, $360 m.) results from tax on business inputs. The rest of this large category comes from separate taxes on use of hydro and natural gas and coal, on insurance premiums, and on motive and other heating fuel.
- Our estimate of unincorporated business income tax is arrived at by taking 6.0% of total Personal Income Tax revenue. 6.0% is the fraction of business and professional and farming and fishing income in total Manitoba income assessed for 1996.

Business Income Taxes:

The chart shows that the personal income tax on unincorporated businesses is an important business tax in Manitoba. We have already proposed changes to the PIT in *Section 8* that would keep Manitoba's tax rates close enough to those of Ontario and Alberta, the main rival jurisdictions for Manitoba firms. This action should help us keep most of the entrepreneurs that provide our key competitive advantage. In Model 1, where the marginal tax rate is relatively higher, we have also proposed a tax credit that is aimed directly at what Manitoba firms identify as their main constraint: the shortage of skilled labor.

The corporate income tax appears to be low enough for Manitoba businesses, judging by the low level of complaint that the Commission heard. Some of this lack of complaint may have been due to recently announced changes to the corporate income tax for small firms that make Manitoba clearly competitive in that tax field: for the first $200,000 of annual taxable income of Canadian-controlled private corporations, corporate income tax rates fell from 9% to 8% last July 1, to 7% on January 1, 2000, and will fall to 6% a year later and to 5% a year after that. The 17% marginal rate for other taxable income is on the high end for provinces, but only marginally so.

Recommendation # 23:

We recommend that the previously-announced schedule of corporate income tax reductions be followed.

Profit Insensitive Taxes:

The other business taxes are a first charge on business income, payable regardless of whether the firm or its owner has any net income. In most cases these taxes are mostly passed on to customers and become a hidden form of consumption tax, but usually some part will be borne by the owners of firms. The part borne by firm owners presents a fairness problem: there is nothing in the system of business taxes to ensure that those firm owners who have to bear the largest business tax burdens are also those with the largest net incomes. That violates our standard of vertical fairness. *Appendix B* explains which owners are likely to be able to pass their taxes on to customers or employees, and which are not.

The firm owners most likely having to absorb their profit insensitive business taxes are farmers. It is no accident that the Keystone Agricultural Producers made the claim that the property tax as it occurs represents "a fundamental flaw in a system which funds a social service through a land-based taxation system." In exempting farm land and buildings from the Education Support Levy, and most farm inputs from the PST, the government has redressed the worst instance of this unfairness.

Profit insensitive business taxes present another fairness problem even when they are passed on to customers in higher prices. Since we do not know how much is passed on by which firm, we have no way of knowing which consumers are bearing the burden of these business taxes, and therefore no assurance that the distribution is fair. It is a reasonable approximation to see the non-profit-sensitive business taxes as poor versions of the consumption taxes discussed in *Section 11*. These are poorer versions in that we have no clear picture of who ends up paying the tax, and there are likely to be harmful side-effects of various sorts on competitiveness of our economy. We would be better to rely more on explicit consumption taxes directly applied to consumption, like the GST or the Value-Added Taxes so common in Europe.

Reducing the Tax on Business Inputs:

Our recommendations for this section are mainly a strategy to move from heavy taxation of business inputs to a greater reliance on sales tax.

The obvious way to do this is to adopt the same sales tax base as the GST. That would mean extending the PST base to include many more services than at present. It would also require us to provide input tax credits to all firms that paid such tax on their inputs. The net cost of those two changes is currently about $100 m. per year of net loss in revenue.

There is an extra payoff to adopting the GST tax base: by harmonizing with the GST, government can save administrative costs of duplicated sales tax administration, and firms will save even more on their own compliance costs. We discuss the decision to harmonize more fully in *Section 11*, and estimate the total annual savings to be in the order of $20 m.

If the extended consumption tax base and the reduced business tax base for the PST left only a small net loss in revenue, or better still a gain, then Manitoba could shift substantially away from hidden consumption taxes that are levied on production and then passed on, towards transparent consumption taxes that are levied explicitly on consumption of goods and services right from the beginning.

What is needed here is to make a start. In *Section 11* we go further.

Recommendation # 24:

We recommend that the province shift gradually away from levying sales tax on business inputs, and that it begin this process by exempting production machinery from the provincial sales tax.

Business taxes and skilled labor:

Each of the taxes on business inputs in the chart above discriminates against a different type of input. The capital and property taxes and sales tax on goods used by business provide another disincentive to acquiring capital for those firms that cannot pass on the taxes. The payroll tax provides a disincentive to employing labor, and particularly the skilled labor that is most expensive.

Manitoba firms identify potential shortages of skilled labor as the chief constraint on their rapid growth in Manitoba. The only way to prevent such shortages is to keep more of our skilled employees here, and to attract more from elsewhere. But the most potent attractor of migrants appears to be the prospect of a well-paying job, a prospect which requires both high wages and abundant job offers. The payroll tax reduces firms' demand for skilled labor, and to the extent that it is passed back to employees, it also reduces the wages they will be offered. Both are steps in the wrong direction.

The new field of growth economics has identified human capital as one of the key engines of innovation, which in turn is the only source of that ultimate free lunch: growing productivity. The more skilled employees there are, the more innovation there will be and the faster our living standards will rise. A payroll tax on skilled labor is the ideal instrument to discourage this process from starting. It is proper that smaller firms are already exempt from this tax, but many of those firms can see the day when they will outgrow their exemption, so they can also see and be discouraged by the disincentive that the payroll tax provides.

Recommendation #25:

We recommend that the payroll tax be given high priority as the business tax to lower, when extra tax room becomes available.

In the meanwhile, we can reduce the disincentive of the existing tax by making it much less progressive. The payroll tax currently is levied at 0% for the first $1 m., 4.3% for the next $1 m., and 2.15% for every payroll dollar thereafter. That medium size firms should have twice the marginal rate of large firms does not seem reasonable, and is therefore discouraging. We do not recommend extending the exemption to all firms, as there is good reason for the exemption to be targeted just to smaller firms. What is needed is to make the clawback more gradual.

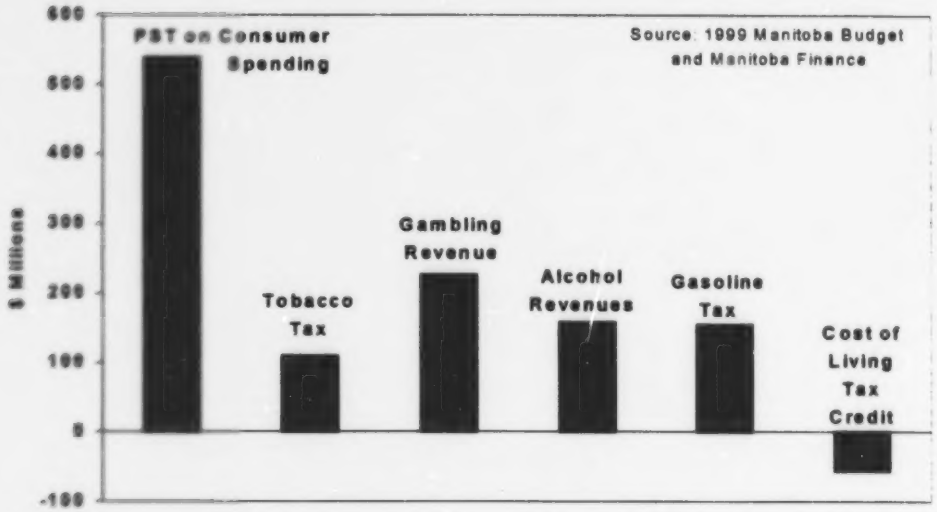
Recommendation # 26:

We recommend that the clawback of the $1 m. exemption from the payroll tax be spread over the next $3 m. rather than just the next $1 m. of payroll.

11. CONSUMPTION TAX REFORM

Consumption taxes in Manitoba include all taxes levied directly on consumers. Most of the taxes collected from business firms are passed on to customers and therefore take the form of consumption taxes, but for the purposes of this report, we treat them separately in the group of business taxes. The chart below shows the totals each consumption tax collects from consumers, as well as the amount handed back to low-income consumers in the Cost of Living Tax Credit. The Gasoline Tax is only partly a consumption tax; some of it is collected from business firms as well.

CONSUMPTION TAXES IN MANITOBA, 1998/99



Our evaluation of the group of consumption taxes as a whole was quite favorable. When some form of consumption tax credit is included to shelter the lowest levels of consumption, consumption taxes make up a generally progressive and reasonably fair tax, one that is relatively easy to collect and has little effect on migration decisions or work effort. That is why we recommended in *Section 7* that higher consumption taxes be one of the additional sources of finance if there is not sufficient tax room to finance our recommended changes in personal income tax.

The fairness of consumption taxes is largely due to the fact that shelter and food and children's clothing are exempt from the Provincial Sales Tax, and domestic heating fuel is exempt from the Motive Fuels Tax.

To Harmonize or Not To Harmonize:

A major question concerning consumption taxes is whether Manitoba should follow Quebec and the Atlantic provinces in having one jurisdiction administering a single Harmonized Sales Tax (HST) on behalf of both governments, to avoid duplicated sales tax administration.

- Sales and excise tax on business inputs is based on the government estimate that 40% of total PST revenue (that is, $360 m.) results from tax on business inputs. The rest of this large category comes from separate taxes on use of hydro and natural gas and coal, on insurance premiums, and on motive and other heating fuel.
- Our estimate of unincorporated business income tax is arrived at by taking 6.0% of total Personal Income Tax revenue. 6.0% is the fraction of business and professional and farming and fishing income in total Manitoba income assessed for 1996.

Business Income Taxes:

The chart shows that the personal income tax on unincorporated businesses is an important business tax in Manitoba. We have already proposed changes to the PIT in *Section 8* that would keep Manitoba's tax rates close enough to those of Ontario and Alberta, the main rival jurisdictions for Manitoba firms. This action should help us keep most of the entrepreneurs that provide our key competitive advantage. In Model 1, where the marginal tax rate is relatively higher, we have also proposed a tax credit that is aimed directly at what Manitoba firms identify as their main constraint: the shortage of skilled labor.

The corporate income tax appears to be low enough for Manitoba businesses, judging by the low level of complaint that the Commission heard. Some of this lack of complaint may have been due to recently announced changes to the corporate income tax for small firms that make Manitoba clearly competitive in that tax field: for the first $200,000 of annual taxable income of Canadian-controlled private corporations, corporate income tax rates fell from 9% to 8% last July 1, to 7% on January 1, 2000, and will fall to 6% a year later and to 5% a year after that. The 17% marginal rate for other taxable income is on the high end for provinces, but only marginally so.

Recommendation # 23:

We recommend that the previously-announced schedule of corporate income tax reductions be followed.

Profit Insensitive Taxes:

The other business taxes are a first charge on business income, payable regardless of whether the firm or its owner has any net income. In most cases these taxes are mostly passed on to customers and become a hidden form of consumption tax, but usually some part will be borne by the owners of firms. The part borne by firm owners presents a fairness problem: there is nothing in the system of business taxes to ensure that those firm owners who have to bear the largest business tax burdens are also those with the largest net incomes. That violates our standard of vertical fairness. *Appendix B* explains which owners are likely to be able to pass their taxes on to customers or employees, and which are not.

One result of the broad base is that our consumption taxes do apply to some of the minimum non-discretionary consumption spending that everybody needs to live in our society -- the spending level we do not associate with ability to pay and that we do not want to tax. In *Appendix E* we estimate what consumption tax is actually paid on non-discretionary consumption. Most of the tax paid is PST.

The Cost of Living Tax Credit has provided an appropriate offset. We have recommended in *Section 8* that it be adjusted to reflect better the actual consumption taxes paid on non-discretionary consumption amounts, and that it be renamed the PST Credit. With these changes, it will be an even better offset.

Rebates for new homes for first-time home buyers:

There is one large sales tax rebate program, operated by the Department of Finance. First-time home buyers who buy new homes receive a sales tax rebate of half the sales tax on construction of the new home. This rebate is not income-tested, but has a ceiling of $2,500. A household receiving the maximum rebate is sheltering over $35,000 of taxable house ingredients from the PST otherwise payable. Manitoba Finance estimates that this is the normal sales tax payable for a typical $100,000 home. For consumers' convenience, the rebate can be calculated as $1.65 per square foot, up to a maximum of 1,515 square feet.

What is the justification for this rebate? The justification is not simplicity or competitiveness. Migration and work effort and saving are not affected by rebates on new homes for first time home buyers. It cannot be fairness either. Qualifying buyers include an individual or an individual's spouse or co-owner who has not owned a home and lived in it as a principal residence in any of the five calendar years prior to purchase. The purchase of a new $100,000 home, can not be considered as entirely non-discretionary consumption. Nor is this rebate likely to be enjoyed more by lower-income taxpayers. Low-income households are generally not in a position to start off by buying new homes. So the beneficiaries are the middle to high income groups, those most able to pay. This rebate violates the ability to pay principle. Although the Commission understands the policy rationale for having a program that stimulates demand in recessionary periods, today is not a recessionary period.

Recommendation # 28:

We therefore recommend that the sales tax rebate for new home buyers be shelved.

12. TAXES AND THE FAMILY

The Commission's terms of reference ask us to analyze and provide suggestions for the tax treatment of families where one parent stays home with their children. Much of our analysis of the personal income tax has reflected on how differently various family types should be treated by the tax system.

As everywhere, our discussion of these issues has been driven by consideration of effects on fairness, simplicity, and competitiveness. In the short term the main issue is fairness. As far as possible, we would prefer the tax system to be both fair and neutral with respect to family structure, leaving that decision to the families themselves.

Current provisions:

Federal: The federal personal income tax is applied to each individual income earner separately, though some tax credits are income-tested on the basis of family income. The marginal income tax rates rise from 17% to 26% and finally 29% at taxable income thresholds of roughly $7,000, $30,000 and $60,000 respectively.

Some expenses can be deducted in arriving at taxable income, but for employees the only family-related expenses are the extra child-care expenses resulting from both parents working outside the home. This deduction is generally not available to any family where one parent stays at home, because such families do not actually pay any of these narrowly-defined "extra child care expenses".

Income is further sheltered from income tax by several family-related tax credits: basic and spousal allowances, extra amounts for the elderly, for infirm dependants, for those with disabilities, for caregiver costs for a parent, for tuition and education and student loan interest expenses, for above-average medical expenses, and for charitable donations.

Finally, the federal government makes two social benefit payments directly to families: the Canadian Child Tax Benefit of up to $1,975 per child, and the GST Credit. Both are income-tested by family income level and are clawed back at certain income thresholds.

Provincial: Under the new Tax on Income system, Manitoba must accept the federal definition of taxable income. The child care expense deduction therefore applies to provincial as well as to federal income tax. Manitoba must also provide all of the existing federal non-refundable tax credits against provincial income tax, in at least the federal amounts. That means there will be provincial tax credits for basic and spousal allowances, with extra amounts for the elderly, for infirm dependents, for disabilities, for caregiver costs for a parent, for tuition and education and student loan interest expenses, and for above-average medical expenses.

Over and above these credits Manitoba supplements the GST Credit with its own refundable Cost of Living Tax Credit, supplemented for age and disability and number of children. The credit approximately refunds the consumption taxes paid on non-discretionary consumption. We have already recommended that this credit be adjusted to make the approximation closer (and be renamed the PST Credit). The province also supplements the federal tuition credits with its own Learning Tax Credit, which we have recommended be replaced with a Post-Secondary Graduation Credit that is more directly aimed at provincial competitiveness.

The province also operates three family-related support programs outside the income tax system: the Child Related Income Support Program (through Family Services) and the Shelter Allowance for Family Renters and Shelter Allowance for Elderly Renters (through the Housing Department).

Family-related taxation issues:

Parliament's Standing Committee on Finance recently asked a subcommittee to look into the fairness with which the income tax system treats single-income families with children. The subcommittee identified the following inequities in our current federal tax system:

1. Because the tax system is progressive and is levied on the individual rather than the family, a one-earner couple will typically pay more income tax than a two-earner couple with the same level of income. This is true whether the couple has dependent children or not.
2. Families with dependent children pay almost as much income tax as families without dependent children, for the same level of income. Exemptions for children have been removed -- to be replaced by an explicit cash payment through the Canada Child Tax Benefit.
3. The Child Tax Benefit (regular and supplemental) of up to $1,975 per child is income tested and clawed back, starting at incomes of only $21,000, meaning that many Canadian families have no allowance for children in calculating their taxes. It is not fair that higher income families with children be treated as if children did not add to their family's non-discretionary consumption level.
4. Child Care Expense Deductions are only available to parents at work or school, and only include extra child care costs that are required by parents being at work or school. There is a $213 supplement to the Canada Child Tax Benefit for all families with young children, though that is available in full only for low-income households, and is reduced by child care expenses claimed,,. Many families therefore have too little allowance for the non-discretionary costs of raising their children at even the minimum, non-discretionary level.

Solutions for Manitoba:

We have already recommended in *Section 8* that the province adjust basic tax allowances to reflect the true cost of non-discretionary consumption for families of every type, including a $3,300 allowance for each extra child. Because the basic tax allowances are not income-tested, every family at every income level will be taxed provincially on a measure of ability to pay that fully reflects actual family structure. In particular, there will be no disparity between single -earner and two-earner families, and no disparity between low-income and high-income families.

Our proposals also flatten the tax rate structure substantially, so that all families with the same total income up to $150,000 will pay the same provincial income tax regardless of how it is distributed among family members. Only 1% of Manitoba taxpayers earned more than $150,000 in 1998.

These two features of our proposals mean that, for the provincial income tax at least, equal ability to pay will be taxed much more equally for all family types.

The extra child care expense deduction will still not be available to families with a spouse at home caring for the children. However, when the basic expenses of raising children are already sheltered from tax for all families, the extra provision for dual working parents may better be seen as the fair provision that it is. Families who must incur extra child care expenses to earn extra income should pay extra tax only on the extra income net of those expenses, because their ability to pay has risen only by their extra net income.

The problem of inadequate expense deduction is broader than just for child care expenses. We have already recommended in *Section 8* that the federal government revise its employment expense deduction to better reflect a wider range of such expenses for employees, so that employees as well as the self-employed will be taxed only on their ability to pay.

Families, children and retirement assets: Another feature of federal tax arrangements that seems still unfair to many families, and especially to women, is the provision that limits use of the tax shelter for contributions to pensions and retirement savings plans. We appreciate that there should be a cap on the total amount of Registered Pension Plan and Registered Retirement Savings Plan contributions that can be sheltered. We appreciate also that the cap should be tied to income levels for each individual or family.

The problem is that tying the cap to each year's income unduly penalizes those spouses who take several years out to look after children or aging parents. Their total retirement needs are just the same as if they continued to work, but their ability to accumulate retirement assets is a lot smaller if they cannot make pension or RRSP contributions for their years out of the labor force. Since most spouses who stay at home to raise young children do return to the labor force later on, this is a very common problem.

The family can still save in tax-sheltered form by contributing to spousal RRSPs during the period one spouse stays at home, out of the income of only the working spouse and in amounts tied to that income. However, most families raising young children find it difficult enough to accumulate financial assets at that stage out of two incomes, and impossible out of one.

What makes more sense for the family is to save less out of the shrunken family income while one spouse is at home and much more in the later years out of the restored family income when both spouses are working again.

One way of making this possible is to allow non-working spouses the ability to make extra contributions to their own RRSP later on when they return to work, for the years they spend out of the labor force.

Recommendation # 29:

We recommend that the provincial government urge the federal government to allow families some extra contribution room in RRSPs, to reflect years when one spouse stayed out of the labor force to look after young children or aging relatives.

13. APPENDICES

A. Why Tax on Income?

B. Who actually pays? A brief guide to tax incidence

C. Taxes and migration: a review of the evidence

D. Taxes, work effort and saving: a review of the evidence

E. Basic allowances and non-discretionary consumption

F. Alternative Income Tax Models

G. Glossary of Terms

H. List of submitters

I. Biographies of the Commission Members

Appendix A: Why Tax on Income?

In Canada, income taxation is a field shared by the provincial and federal governments. The latter, however, exerts a significant control over income tax policy and administration in Canada. Under the Tax Collection Agreement, the Canada Customs and Revenue Agency administers and collects both governments' personal income taxes in all participating provinces and territories (that is, all except Quebec).

The current arrangement offers several important benefits, including:

- a common definition of taxable income;
- a common set of deductions and credits;
- a common set of rules to determine the taxpaying unit and matters like residency; and
- a single tax administration which generally allows Manitobans to file only one annual income tax return for both federal and provincial income tax purposes.

The current taxation agreement requires provinces to use the basic federal tax as the base on which their own income tax is levied. This arrangement is known as "Tax on Tax".

One result of the present arrangement is that provincial income tax revenue is automatically tied to the federal government's tax decisions. Almost every federal budget introduces changes to the Personal Income Tax system that automatically affect provincial as well as federal revenues. No provincial government objected when federal tax increases automatically resulted in additional provincial revenues. Now, with federal rates expected to decline, many provinces are concerned.

Some provinces indicated they would consider creating their own, independent, provincial income tax system. This would require taxpayers to file two returns, increase compliance burdens for employers, and jeopardize the other benefits of the tax collection agreement.

An alternative to the present system would change the tax collection agreements to allow provinces to levy tax directly on taxable income, the same way as federal taxes are calculated. The "Tax on Income" approach would allow provinces to levy Personal Income Tax directly on taxable income, rather than as a percentage of basic federal tax. Under this approach, provinces could, if they chose, implement a schedule of one or more rates applied to taxable income. They would also be able to create additional non-refundable credits, with some restrictions. This Tax on Income approach would preserve the benefits of the current system, most importantly, a single tax administration.

The Tax on Income system would:

- simplify the way personal income taxes are calculated and allow Manitoba to abolish the net income tax and surtax;
- improve transparency and help taxpayers identify more readily the taxes imposed by each order of government; and
- preserve the tax collection agreement, the common tax base and common rules in all participating provinces and territories.

The federal government has indicated that the Tax on Income system will be generally available to provinces for the 2001 taxation year. The Manitoba government has already decided to move to a Tax on Income system. The proposals and recommendations in this report therefore assume a Tax on Income system, rather than the current Tax on Tax arrangement.

Appendix B: Who Actually Pays? A Brief Guide to Tax Incidence

Both the Alberta and the Saskatchewan Tax Commissions have made the point that all taxes are ultimately borne by individuals, and not by firms. Those individuals are either customers, or employees, or owners of firms. Tax incidence is the body of analysis that predicts how much of the burden of any tax will be borne by various groups of taxpayers. It is the goal of tax incidence analysis to predict what portion of the burden of any one tax will be borne by each of the three groups.

In the modern theory of public finance, this question is best answered by simulating models of general equilibrium of entire economies, with and without a tax change, and then looking to see who is made worse off as a result of the tax. The older, partial equilibrium approach looks just at the markets directly affected by each tax and provides simpler answers that are almost as accurate. This Appendix sketches the logic and predictions of the older approach.

The central idea: You can't tax what won't stand still. The central idea underlying tax incidence is that individuals who are most able to shift out of any activity being taxed will end up paying the least. Individuals totally unable to shift will end up bearing all of the tax burden.

"Shifting out of any activity being taxed" means different things for different taxes. If, for example, employment in production of grain bins for sale in Manitoba is being taxed, the employer can escape the tax by producing them elsewhere, by not reporting the output (that is, going underground), by producing something other than grain bins, or by selling them elsewhere.

To escape the much more general provincial income tax, firms must either leave the province or go underground. To escape the general provincial sales tax, firms and customers must sell and buy out of province or go underground. To escape the payroll tax levied on larger employers, firms must use fewer employees and more capital equipment, and employees must move to smaller firms or to jurisdictions without a payroll tax.

When and how are taxes passed on? In competitive markets where firms can easily start up and close down, any tax which is collected at the same rate from all firms will eventually be passed on to customers in higher prices, because (a) the tax will initially lower profits below what is available in other lines of business, (b) some firms will leave the market, and (c) the reduced supply will drive prices up until those prices cover the extra tax cost, leaving the remaining firms with the same profits as they could expect elsewhere. The process may take several years, but only in the first few years will the producers rather than the consumers be bearing much of the tax load.

In a monopolistic situation where the existing firm does not need to fear entry of rivals, but also cannot easily find alternative lines of business that are as profitable, it will not abandon the market it dominates just because a sales tax is imposed. Its remaining profit after the extra tax is likely to be still greater than it could generate in more competitive markets elsewhere. The firm will try to pass on the cost to its customers, but large numbers of customers will shift or threaten to shift to other goods or services, such that

the firm will be forced to absorb part of the tax itself in the form of lower monopoly profits.

The same sort of predictions apply to markets for inputs - markets for labor and for capital equipment. If a payroll tax is collected from employers who can easily contract out their production elsewhere at the same profit margins, and the employees cannot easily find work elsewhere, the departure of even a few employers will eventually lower wage rates until the employers are bearing little of the tax and employees are bearing almost all of it. Until wage rates fall, the employees and the social safety net will bear the burden in the form of higher unemployment rates.

Incidence of Business Taxes in Manitoba. How does the logic above apply to the specific circumstances of Manitoba, particularly for the variety of taxes that are collected from business firms?

All business taxes raise the cost of production. The extra costs are fully passed on to customers in higher prices whenever customers cannot escape by turning to other suppliers or other goods not subject to an equivalent tax.

All Manitoba suppliers are subject to sales taxes on business inputs, but some suppliers in some markets will be from out of province and some of those out-of-province suppliers will not have an equivalent tax to pay. The threat of losing market share to out-of-province rivals will prevent some Manitoba firms from passing on all of the tax to customers. In an open economy like Manitoba, it seems fair to say that most output of goods and a significant share of output of services is from firms that must compete vigorously with out of province rivals, so increases in any general tax on business by Manitoba alone will be absorbed partly by the firms' owners in lower profits as well as by their customers in higher prices.

Extra business costs will be passed on to suppliers of inputs in lower wages and other input prices if the employees/suppliers cannot easily move or threaten to move elsewhere. Below, we deal with the extreme case of suppliers of land. Employees with more generalized skills have a wide range of alternatives to which to turn in an economy as diversified as Manitoba's, though less so in rural areas where there are few employers. Employees with specialized skills are likely to be part of a labor market much larger in size than Manitoba's - nurse practitioners, medical doctors and information technology staff come quickly to mind - and many can easily move to equivalent offers elsewhere if their local employer should threaten to pass extra business tax costs back to them in lower salaries. Other employees are likely to absorb a portion of business taxes in lower earnings.

Taxes on land: Taxes on unimproved land, such as the land portion of the commercial property that is assessed for property tax, represent an extreme case. Since the owner/suppliers of the land cannot move it elsewhere if its rental rate drops, they therefore absorb all of the burden of any extra tax on land. Land rents net of land tax go down by as much as the land tax goes up. Only this way will all of the commercial land stay in use, which every landowner wants.

Any permanent drop in rent net of taxes produces a proportional drop in land values. Such a large drop in land values compensates potential buyers from having to bear any of

the burden of the tax now or later. Their carrying costs for the land are lower, because of the lower purchase price, by enough to offset the extra land tax costs. So the fact that unimproved land cannot be shifted to other alternative uses when taxed means that the burden of the land tax is borne only by the person owning the land when the tax is imposed, in the form of a large capital loss in land value.

Fairness and Competitiveness: There is nothing automatically fair about the pattern of incidence of any of the taxes discussed above. Part of the pattern is obviously unfair: employees with fewer or less portable skills are likely to bear more of the burden of business taxes than employees with more skills or more portable skills. Yet it is the latter employees who have the greater ability to pay.

Similarly, there is nothing automatically competitive about the pattern of incidence of business taxes. Part of the pattern seems obviously uncompetitive: businesses without out-of-province rivals, such as most licensed professionals serving the Manitoba market, are better able to pass on general business taxes to customers than are goods-producing firms competing in world markets, such as farmers and manufacturers.

If we do not want to rely on such unfair or uncompetitive taxes, we must rely more on other revenue sources such as income taxes or explicit consumption taxes or even user fees, rather than taxes on business inputs.

Appendix C: Taxes and Migration;

A brief review of the evidence

Purpose: Competitiveness of a province's tax system refers to its ability to keep taxable activity in the province. Lack of competitiveness leads to out-migration of people who take their skills and capital and spending with them. Significant out-migration can tip a province's scales from continued growth and prosperity to almost unstoppable decline. Many residents of small towns on the Prairies have already seen out-migration make such a difference to their town.

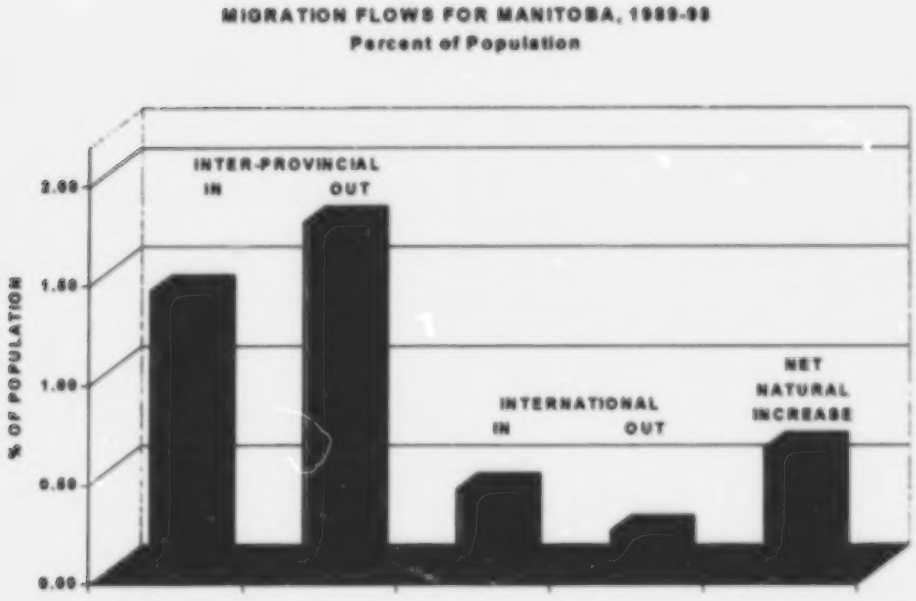
If the cost of having an uncompetitive tax system can be so large, it is vital to have a solid estimate of how sensitive migration will be in the future to any large tax differences that may occur between provinces. Producing and justifying such an estimate is the purpose of this appendix.

1. What is migration? Migrants are those changing their province of residence, permanently. A Manitoban migrating to Alberta will therefore show up in Census data as a current resident of Alberta, and a former resident of Manitoba. Migrants do not normally include temporary visitors, such as those working in Canada on NAFTA visas but declaring the US as their home.

2. How large is migration? The chart shows migration flows over the past decade as a percentage of Manitoba's population. Out-migration has been greater than in-migration over the past decade, however the net flows have reversed in the past year. Net international immigration, (that is, subtracting all brain drains to the US from the gross inflow in the chart), has been positive, but on a smaller scale, and has steadily dwindled over the decade. Net interprovincial out-migration has been more than offset by the natural population increase (births less deaths). Over the decade, net interprovincial out-migration has lowered the population by just over 5%. Natural increase and net international in-migration have raised it by 8.4%.

Domestic versus international : Interprovincial migration flows are much larger than international migration, even though US states are in close proximity and even though tax differences are often much larger than between neighbouring provinces. For instance, John Helliwell has calculated from census data that 70 graduates of the University of British Columbia had migrated to other provinces in Canada, for every one that had migrated to the US to a state of similar population and distance. For the Canadian population as a whole, seven had migrated to another province for every one that had migrated to the US.[11] For Manitoba, the chart above shows that out-migration (mainly to the US) is one tenth of out-migration to other provinces. Clearly migration flows to the US are an order of

[11] *Do National Borders Matter?* (Washington, DC: Brookings, 1998).



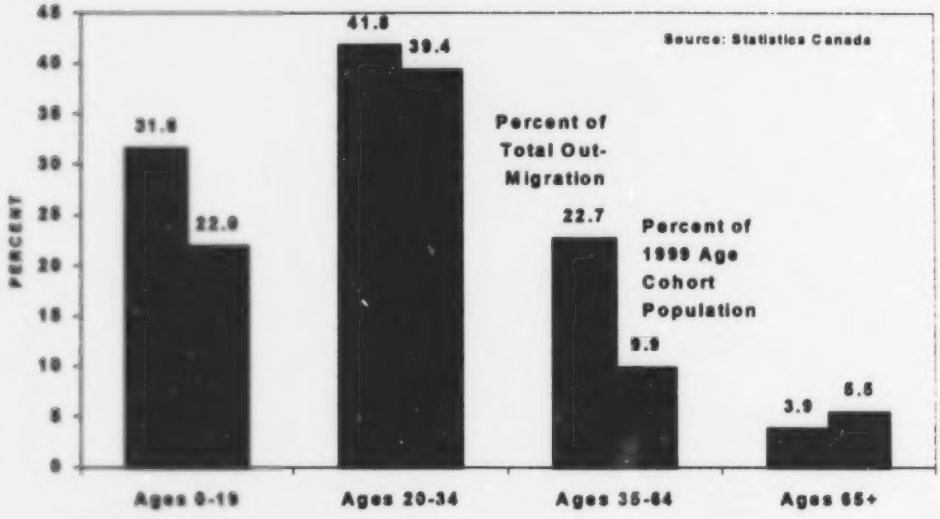
magnitude smaller than flows to other provinces. Unless US immigration limits become much less restrictive than they are now, this seems likely to continue. Furthermore, Statistics Canada estimates that half of those who emigrate obtain a (permanent) green card to work in the US; the other half return to Canada within ten years. The major threat to continued growth of Manitoba's population is migration to other provinces.

3. Who migrates? There are several ways to categorize migrants.

- **By age:** The chart below shows the proportions of Manitoba's out-migrants to another province by age group. Those in the 0-19 age group are more or less evenly spread by age, and it seems reasonable to assume they leave as family members of families headed by older out-migrants in the 20-34 and 35-59 age groups.

  The key fact in the age breakdown is that the 20-34 group accounts for twice as many out-migrants (ignoring attached children) as the older 35-59 group. This is despite the older group normally being at higher, mid-career income levels, and therefore more sensitive to tax rates, and also being a wider age range by ten years. The 20-34 age group appears to be by far the most mobile group in the province. The dominance of the young in migration flows is even stronger than the chart suggests if one allows for some of the 18 and 19 year olds in the 0-19 age group being separate, unattached migrants rather than dependent family members.

TOTAL MANITOBA OUT-MIGRATION TO OTHER PROVINCES, 1988-98



- **By education level:** Lise Bastarache of the Royal Bank's Economics Department looked at the patterns of accumulated migration revealed by the 1996 Census data. She found that:
    - interprovincial migrants are more likely to be better educated than the general population.
    - For the country as a whole, almost a quarter (23%) of interprovincial migrants held a university degree, compared with only 13% of the general population. At the other end of the educational attainment scale, only 4% of interprovincial migrants had less than a grade 9 education, compared with 12% of the general population.[12]

Younger people are on average better educated than the general population, as educational levels have been rising steadily over the last four decades.

In a thorough study reported more fully below, K. B. Newbold investigated migration decisions of those already away from the province of origin. He estimated that after controlling for many other factors (including coldness of the destination) those with a university degree were 45% less likely to migrate back home than those with no postsecondary training. In other words, those with more education are significantly more mobile.

[12] "Interprovincial mobility of highly skilled workers", *Royal Bank of Canada Current Analysis*, October 1999.

- **By income level:** Bastarache did not find that interprovincial migrants tended to have income levels different from the general population. This is consistent with the more educated younger people being by far the more mobile. They will tend to earn more because of their better education, but to earn less because of their youth.
- **By type of occupation:** Bastarache did not give the share of migrants that were "knowledge workers", defined to include those in "management, business, finance, administrative, natural and applied sciences and health". However, Manitoba's net interprovincial out-migration of knowledge workers over the years 1991-96 was 3% of its stock of knowledge workers, whereas its net out-migration of all ages over 15 represented only 2% of its total population over 15. By contrast, Manitoba's net loss of university graduates over the same period was 5% of the province's stock of university graduates, a much higher loss ratio.
- Canada as a whole was ranked very low on an international scale of "likelihood of the well-educated staying" in the world competitiveness survey conducted by IMD, a Swiss business school; we were below Hungary and Indonesia, just above Turkey and South Korea. However, the evidence on which the ranking is based turns out to be nothing more than a collection of opinions, of those businessmen contacted by the school who chose to fill out and return their questionnaire.

4. Is the Problem Special for Information Technology People ? Business complaints dealing with shortages of IT people are not peculiar to Manitoba. The Software Human Resources Council's survey of employers suggested that there might be as many as 30,000 vacant positions in the field of information technology. However, a similar estimate for the US is 400,000. The sector has been growing at 16% annually since 1992, according to the SHRC's president, so it is not surprising that it has outstripped its labor pool in both countries.[13]

Stories in the press during the summer frenzy over IT shortages did point out that Canadian employers were competitive in paying salaries, so the shortages in Canada are not driven by Canada-US income differentials - at least, before tax.[14]

5. Do taxes affect migration? This question must immediately be asked more carefully: To what extent do taxes affect migration flows, once we have allowed for the effects of all other forces thought to affect migration? Simply comparing tax rates and migration flows without any allowance for the other factors is bad science and not to be taken seriously.

Review of the evidence: There have not been many careful studies of migration flows between provinces, let alone between provinces and US states. We reviewed the research we could find to explain migration behavior in the past. We now present summaries of various viewpoints as to what can be inferred for the future from migration behavior of the past.

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[13] Mark MacKinnon, "Emigration to the US is slowing", *Globe and Mail*, July, 1999.
[14] Michael MacDonald, "Taxes eat our high-tech pay edge: study", *Winnipeg Free Press*, July 15, 1999, p. B7

(a) Bastarache's analysis for the Royal Bank compares net migration flows to differences in the one variable that economic theory has long suggested as the most important cause: differences in employment prospects. She finds the migration patterns consistent with this cause, if employment prospects are measured correctly by employment growth rates. "The employment growth ranking for 1991-96 is very similar to the net interprovincial migration flows ranking". For the period since 1996. she adds "The interprovincial migration picture has improved for the four remaining provinces - Ontario, Manitoba, Saskatchewan and Alberta ... This coincides with an improvement in the employment growth ranking of those provinces."[15]

She also found the following:

1. Between 1991 and 1996, seven provinces (including Manitoba) incurred a net loss of knowledge workers (those in management, business, finance, administration. natural and applied sciences and health)
2. In the same period 53% of migrants declared incomes of less than $20.000. indicating that most migrants are not necessarily the highest income earners, but possibly are younger employees.
3. Only British Columbia, Prince Edward Island and Alberta managed to attract more high income individuals from other provinces than they lost.
4. Manitoba was amongst four provinces that lost a larger than average number of university graduates to other provinces, with Alberta gaining many more of these migrants than average.

(b) The federal Department of Finance has tried to estimate directly the effect of differences in marginal tax rates between provinces, on migration flows measured in proportion to the population of the receiving province. Rescaling migration flows as proportions of the population of receiving provinces makes the results less useful for our study of out-migration. More importantly, the federal study uses only differences in unemployment rates to reflect all other influences on migration flows (employment prospects, expected earnings levels if employed, government services or transfer payments receivable, etc.). Since British Columbia, for instance, has a higher unemployment rate than Manitoba even when BC is booming and Manitoba is not, their results would not be credible even if they had been in a form we could use. In the study reported below, Newbold found that the difference in unemployment rates did not help explain individual migration decisions once differences in employment growth had been included.

(c) K. B. Newbold used the 1986 Census data to study over 5,600 migrants between the ages of 20 and 64 who were already away from their province of origin.[16] His objective is to explain their decision to migrate back home again rather than elsewhere. This is very relevant to Manitoba's situation, given the number of former Manitobans living

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[15] Lise Bastarache, *Interprovincial mobility of highly skilled workers*, Royal Bank of Canada Current Analysis, October 1999.p. 4.

[16] K. B. Newbold, "Income, self-selection, and return and onward interprovincial migration in Canada," *Environment and Planning A*, June 1996, 1019-34.

elsewhere. Newbold's sophisticated regression explanation takes into account age, sex, marital status, mother tongue, level of education, and family type of the migrant, as well as population sizes and distances, cultural similarity, coldness, and differences in (i) personal income per capita after tax, (ii) employment growth over the previous five years, and (iii) unemployment rate.

In Newbold's estimates *the tax rate does matter*, as the income measure used is an after-tax measure which combines income level and tax rate. An extra $1000 of after-tax income in the province of origin raises the propensity to migrate back there, rather than elsewhere, by one third. That is, of 1000 people who had already decided to migrate, 333 more of them would have migrated back home if their home province had offered that much extra disposable income.

From Newbold's results it is not possible to separate out the effects of extra income from the effects of lower tax rates. This is done in the next study.

(d) Gideon Rosenbluth has used interprovincial migration flows from 1966 to 1991 to estimate what kinds of provincial policies would and would not attract taxpayers from other provinces.[17] His evidence of migration is 26 years of annual flows between the 90 possible pairs of source and destination provinces in Canada. His estimating technique is multiple regression. In his explanation of migration flows he includes as determinants the relative sizes of source and destination populations, and the standard migration incentives of (a) real or inflation-adjusted GDP per capita or the real wage, and (b) employment growth (as an index of job prospects). These variables explained 71% of the variation in Manitoba's net migrations to other provinces.

Rosenbluth was unable to detect any extra impact from including such extras as Alberta's Heritage Fund balance, or from replacing the before tax real wage or GDP per capita with the after tax real wage or GDP per capita. That is, the differences in tax rates that existed over the 1966-91 period were not large enough to matter to migration flows.

(e) John Helliwell has used census data for Canada for 1991, and for the US for 1990, to study the causes of the cumulative migration that these censuses count.[18] His data consist of cumulative migration flows between each possible pair of provinces and between each of them and the US, and then between each pair of US states, and between each state and Canada. His explanatory variables are relative population sizes, distances, real per capita personal income differences, whether Quebec is either source or destination, and whether the migration crosses a national border. Together, they explain an impressive 91% of the variations in migration flows.

Taxes play no part in Helliwell's study, but one can determine an upper bound on what their impact might be from the impact of differences in before tax incomes. For interprovincial migration, a 10% increase in income in a destination province raises out-migration flows to that province by about 40%. We will use this result in an illustrative calculation in the conclusion. The same stimulus would cause only a 4% increase in out-

[17] "Interprovincial migration and the efficacy of provincial job creation policies", *Canadian Business Economics*, Winter 1996, 22-35.

[18] John Helliwell, *Do National Borders Matter?* (Washington, DC: Brookings, 1998).

migration to the US, as interstate migration flows are estimated to be only one tenth as income-sensitive as interprovincial flows in Canada.

To cause a 10% increase in disposable income, taxes would have to fall by more like 15% of their initial level. Therefore, the upper bound estimate of tax rate impact is one of just under 3% increase in out-migration to the destination province for every 1% extra tax rate that the source province maintains. Remember that this upper bound estimate assumes that migrants do in fact consider taxes as well as before-tax income prospects.

6. How relevant is evidence from the past? There are several reasons for thinking that whatever past behavior was, future behavior is likely to be substantially different.

First, the spread of e-commerce will make national borders less relevant by allowing knowledge workers to work electronically anywhere they want, while living in suburban Winnipeg. It is already the case, for instance, that electronic firms financed in Silicon Valley end up doing their research and development back home, but storing their work on servers in Silicon Valley. We suggest in *Section 5* of the Report that the greater feasibility of electronic commuting will make households less likely to migrate physically just to find a job, and more likely to migrate for other, more esthetic reasons.

Second, the Internet has made information on the attractions of possible destinations so much easier to search out, that each location now faces more effective competition from all other locations. Sensitivity of migration flows to all differences between provinces should be higher in the future, just because the potential migrants are so much better informed. Information-gathering is one of the up-front costs of migration, and such costs have gone down.

Third, the fact that many Manitobans have already migrated to other provinces and US states, and that many more have spent some time working in the US on NAFTA visas, means that Manitobans are much more likely to have contacts in those other jurisdictions; at the least, such contacts reduce the uncertainty of moving out permanently, and in some cases the contacts are former Manitobans actively encouraging their former co-workers to join them.

Fourth and most important, income tax differences between jurisdictions have been much smaller over most of the past than they will be in the near future. The personal income tax burden, as a share of GDP, was close to 10% in both Canada and the US over most of the 1970s and the first half of the 1980s. A gap of over three percentage points has opened up since. Between provinces west of Quebec, the range of top marginal income tax rates has widened from at most three percentage points (of income) in the 1970s and early 1980s to 5.5 percentage points in 1999. Since most of the costs of migration – moving expenses, arranging new schools and friends and business contacts, etc. – are fixed, migration flows should not be expected to respond to tax differences as long as those differences were less than migration costs. That would explain the lack of significant measured response of interprovincial migration to tax differences over most of the past half century. As soon as tax differences exceed migration costs, however, as they surely do by now, migration flows should start to respond much more vigorously. This is consistent with what we have seen in the behavior of migration flows from inside to

outside the City of Winnipeg's tax boundary, which seem to have increased dramatically as city property taxes have risen over the past decade.

7. Are Migrants Few but Special? Even if tax-induced migration flows were not large as a share of the population, they could still be very damaging to the province if migrants included Manitoba's most prized talents: its gold medal winners, its entrepreneurs, its innovators. Is this to be expected?

There is no evidence on this question, as emigrants do not leave behind a personality inventory at the border. Several pieces of evidence seem relevant, however. First, Statistics Canada's measures show that about half of all Canadian migrants to the US come back to Canada within ten years. Indeed, some go to the US to receive broader experience, and are better for it when they come home. If they are the elite when they leave, they should be even better when they come back.

Second, migration is a two-way flow. Manitoba loses, and Manitoba gains. If there is a case that Manitoba's losses are its elite, then we should also expect that Manitoba's gains are some other area's elite.

Third, our interprovincial losses of people have been offset, for all but the medical field, with net international migration from the rest of the world. Just in terms of numbers of trained people, we take into Canada far more educated people than we send out. Each year in the 1990s, about 8,500 university-educated Canadians moved south to the US. Each year 33,000 university-educated immigrants came into Canada. For knowledge workers in general, Canada as a whole gains far more in this category from elsewhere than it loses to the US.

8. Do we need to worry most about being competitive with the US, or with other provinces? The first chart shows that international out-migration from Manitoba has been about one tenth of inter-provincial out-migration, over the last ten years. These have been years of vigorous growth and much higher earnings in the US, with relatively more open immigration restrictions than in the previous two decades. Other provinces would appear to be the most serious threat by far.

9. How important are Alberta and Ontario? Aside from income differences, what attracts migrants to a destination province is its population size (a proxy for its range of opportunities) and its closeness. Helliwell's research can be used to estimate what proportion of total Manitoba out-migration would be attracted to Alberta and Ontario, even without any income differences, just because of their size and distance from Manitoba. The combined share is over 60%, two thirds of which is to Ontario. British Columbia is sufficiently far away, and Saskatchewan sufficiently small, that their shares are just over and just under 10%, respectively. Alberta and Ontario are indeed the two provinces over which to worry.

10. What is a reasonable estimate of the future sensitivity of migration to tax differences? If the tax is obvious or well publicized, as differences in top marginal income tax rates tend to be, it seems prudent to assume some impact even though research using past data has not turned up any firm estimates. A sensitivity that is half as large as sensitivity to a change in before-tax income seems a reasonable first approximation for past migration flows. Helliwell estimated the latter as a ratio of 40 to

10: a 10% increase in before-tax income in some other province raises the out-migration flows to that province by 40%. Our estimate is that a 10% change in after-tax income caused by lower taxes would have raised migration flows by 20%.

For future migration flows, for reasons listed in Point 6, we should increase the sensitivity somewhat. We increase it by half again, to be concrete. Our estimate is therefore that a 10% change in after-tax income in some destination province that is caused by lower taxes will raise future migration flows to that province by 30%.

To illustrate the effect of our rough estimate in a simple context, we suppose that Manitoba chooses to keep a flat personal income tax rate of 17% when Alberta and Ontario both have moved to flat rates of 11%. This 6 percentage point difference in tax rate above the zero-tax threshold would raise after-tax income (in Alberta and Ontario) by nearly 4% for a mobile, middle-income household. We should expect out-migration to those two provinces to rise by 12%.

This would mean an 8% rise in total out-migration, since Alberta and Ontario normally account for two thirds of Manitoba's out-migration. An 8% rise in total out-migration translates into an extra 1,800 people lost from the province each year. That is, about 300 people lost each year for every one percentage point difference in marginal personal income tax rates. Over a decade, that is 18,000 people. In total, those 18,000 people would have contributed to the province in many ways, not the least of which is in tax payments of roughly $50 m. per year.

11. What is the pessimistic, worst-case scenario? General commentary from the business sector suggests far greater out-migration than in our illustration above. How great might out-migration be, under a pessimistic, worst-case scenario?

A pessimist might well assume instead that (a) the gap in income tax rates would widen to 9% instead of just 6%, (b) British Columbia and the US would have these much lower rates as well as Alberta and Ontario, and (c) future migration flows would be half again as large as our very approximate estimate. Those changes make the out-migration over three times as large: over 6,000 people per year, or 60,000 over a decade. This is, over 650 extra people lost to other provinces and the US for every one percentage point difference in marginal income tax rates.

To keep tax-induced out-migration down to no more than 1,000 extra people per year under these pessimistic assumptions, the government would have to shrink the tax difference to 1.5 percentage points.

Appendix D: Taxes, Work Effort and Saving

This appendix discusses the effect of taxes on work effort, whether tax credits and transfers affect household choices, and how taxes affect savings by Canadians.

One of the fears of policymakers in the area of income tax and the social safety net is that higher tax rates and more generous benefits will weaken incentives to work. The result would be a lower income tax base, and excessive draws on the social safety net programs.

Taxes and Work Effort:

"Lower personal income taxes, ..., are thought to increase the incentive to work. . .consequently there will be a rise in the number of hours worked, and therefore output, without additional inflationary pressures. Lower tax levels will boost not only the level of demand, but also the level of supply in the economy." [19]

Authors Boadway and Kitchen found that while the effect of taxation on work effort is difficult to predict,[20]

> "the only predictable factor is that for a given amount of tax payment, the individual will work more the lower is his marginal tax rate. . .In the shorter run, tax-induced changes in work patterns may occur among the self-employed or among those who work overtime, at casual jobs, or on second jobs. In addition, income taxes may affect the work patterns of secondary workers such as additional family members—a potentially important source of labor supply."

They go on to say the following: "In reality, most individuals are unlikely to make work-related decisions on the basis of their marginal tax rates alone, primarily because they are unaware of them. . .enjoyment, prestige, recognition and influence derived from working may have a greater impact on the supply of labor than personal income taxes have."

One can conclude that households do not change their labor supply significantly, even in response to explicit changes in income per hour. The reason is that higher income has two effects that pull in opposite directions. Higher real wages increase our total income, and our typical response to income is to buy more of all the good things of life - including leisure, which means working less. On the other hand, higher real wages means that the income foregone by not working is now higher, and our typical response to increases in cost of some item is to buy less of it - which means less leisure and working more.

The net effect of higher real wages on work effort in the UK, in the US, and in Canada has been that a 1% rise in real wages actually lowers work effort of males by 0.1 to 0.2%.[21] Results from the Manitoba Income experiments of the 1970s suggest that labor

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[19] Robert B. Fairholm, *Standard & Poors' Canadian Forecast Summary* Summer 1999
[20] *Canadian Tax Policy*, (Toronto: Canadian Tax Foundation, Third Edition, 1999)
[21] A B Atkinson & J E Stiglitz, *Lectures in Public Finance* (New York: McGraw-Hill, 1980).

supply of females is twice as responsive, but the responses are still small. It follows that changes in income tax rates will not have large effects on labor supply.

How Large are Effects of Tax Credits & Transfers on Household Choices? Will the take-up rate for social programs rise quickly when those programs are changed? A recent Working Paper sheds light on this question by reporting the results of social program reform in a context similar to Manitoba's.[22]

The authors first measured the marginal and average tax rates implied by the various claw-back rates of the social safety net in California. Those rates are high, as in Canada. They then estimated two separate response rates to changes in the programs - one for single parents, and another for primary and secondary earners in two parent households.

Their results included the following:

1. If the earned-income tax credit (like our Child Tax Benefit in Canada) is increased by enough to raise the net wage of single workers by 4.6%, then
2. (a) labor market participation of single parents rises from 64 to 65.5 %;
   (b) labor market participation does not change significantly for either primary or secondary earners in two-parent households;
   (c) participation in welfare programs drops from 55 to 51.2% for single parents and from 21 to 19.1% for parents in two-parent households.
3. A 50% subsidy for child care expenses would increase labor market participation from 64% to 66.9% for single parents and from 56 to 57.9% for secondary earners in two-parent households.
4. A 20% reduction in child benefit guarantees would raise labor market participation of single parents from 64 to 65.6% and reduce their participation in welfare programs from 54 to 52.8%.

The Influence of Taxes on Savings. The effect of taxes on the average savings rate is not clear. Income from some savings is sheltered from income tax by being in RRSPs and RPPs, while other income from saving is not. What is clear is that the differential taxation treatment of different savings instruments has skewed people's preferences for those instruments. Contributions to the CPP/QPP, the RRSP and RPP schemes accounted for 40% of all savings in 1971 but 83% of all savings in 1995.

Boadway and Kitchen's conclusion goes a little further:

". . .although the income tax system provides relatively generous shelter for retirement savings, capital income that cannot be sheltered is taxed at relatively high individual rates. This state of affairs provides a disincentive to save and thereby reduces the funds

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[22] Scott Houser and Stacy Dickert-Conlin, "The effects of after-tax wages, transfer payments, and child care expenses on labor market and transfer program participation", *JCPR Working Paper, Oct. 1998, #7* (Northwestern University / University of Chicago: Joint Center for Poverty Research).

available to capital markets (and for future consumption). It also increases the incentive to avoid taxes by holding assets abroad."[23]

[23] Robin Boadway and Harry Kitchen, *The Canadian Tax System* (Toronto: Canadian Tax Foundation, 3rd ed., 1999)

Appendix E: Basic Exemptions and Non-discretionary Consumption

We have several choices for determining the minimum, non-discretionary amount that should be exempt from tax. Of these, the Federal/Provincial/Territorial Working Group's *Market-Basket Measure of Poverty* seems the best, certainly much better than the Low Income Cut-Off or even Statistics Canada's Low Income Measure (50% less than the median income for the reference family). We have already looked at the Working Group's Report on its preliminary measure.[24]

The Market Basket Measure is made up of four ingredients. We can use prices for three of them from Manitoba Agriculture's Budget Guides 1999, provided by Janet Sampson of the Home Economics Directorate of Manitoba Agriculture. The four ingredients are:

(1) Food costs: sufficient to provide the Nutritious Food Basket (identified by the Ontario Ministry of Health and used by Manitoba Agriculture's Budget Guides). For the reference family of four (two adults, two children), this is **$5,964** in Winnipeg.

(2) Clothing costs: identified in the Working Group report as 75% of the clothing budget prepared by the Metro Toronto Social Planning Council. Manitoba's Budget Guides follow the example of the Metro Toronto Social Planning Council, so we can use the Budget Guide amount for the reference family of four: 75% of that amount is **$3,590**.

(3) Shelter: identified in the Working Group report as being the rental of a three bedroom apartment, for the reference family of four. From Manitoba Agriculture's Budget Guides 1998, this costs **$8,616** in Winnipeg.

(4) Other (personal care, household needs, furniture, telephone, public transportation, reading, recreation, entertainment, school supplies): identified in the Working Group report as 60% of total food and clothing costs. 60% is the average of the proportions found for these other costs in detailed budgets of Social Planning Councils of Montreal, Hamilton, Toronto, Winnipeg, and Edmonton. For Winnipeg, 60% of (5,964 + 3,590) is **$5,732**.

Total: All four items add up to **$23,902**.

Other adjustments:

1. The prices used are averages of regular prices for new items, such as would appear in the Sears catalog. This overstates the prices achievable by finding sales, buying in bulk, or buying used items.

2. The totals appear to ignore a few minor expenses such as out of pocket health care costs for dental care, prescription drugs, and vision care. More seriously, the budgets make little allowance for the costs of replacing appliances, as though one need not think that far ahead. Finally, the budgets make no specific allowance for out of pocket child care expenses where both parents are working. This last factor is looked after by the

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[24] Federal/Provincial/Territorial Working Group on Social Development Research and Information, *Construction of a Preliminary Market Basket Measure of Poverty* (Mimeo, March 1998)

federal child care expense deduction, which effectively extends the basic zero-tax threshold for affected families.

3. The costs of basic consumption outside Winnipeg differ from those in Winnipeg, in several ways. Store prices tend to be higher both because of smaller-scale stores, and because of transport costs (especially in remote communities). Shelter costs vary widely between communities. Rural residents are more likely to depend on a car rather than public transport, and to own houses rather than rent apartments. Cars and houses add to the out of pocket cost of consumption by roughly the amount of mortgage service costs (for owning a home), and overhead costs of licenses, service, and depreciation (for operating a car). The marginal costs of operating a house are similar to the rental of an apartment, while the marginal costs of running a vehicle are close to the costs of riding on public transport. On the other hand, rural residents are more likely to have their food purchases supplemented with locally grown produce and even meat from hunting.

4. CPP contributions and EI payments will eat up part of any income earned, but both of those are explicitly allowed for as non-refundable tax credits on the federal tax form. No extra provision is required in the basic exemption amounts.

5. The income-tested, refundable sales tax credits for GST and PST are not reported as income for income tax purposes, but they do finance part of the minimum consumption basket, so the amount of reported income that must be sheltered in the exemptions for non-discretionary consumption should be smaller by the amounts of these two credits. These are currently $190 (provincial) + $199 (federal) for taxpayer and spouse or equivalent, and $25 (provincial) and $105 (federal) per child under 18.

6. The Budget Guides identify several other items that should be in some households' budgets, such as basic life and disability insurance, and some saving. The amounts of these required will vary across households. They do not appear to be part of the Working Group's measure of poverty levels.

Adjusted total: Our estimate of the effect of all of the adjustments above, but especially points 1 and 5, has been to reduce the total cost for the reference family of four to **$22,000**.

Conversion to exemptions: For other types of household, the amounts are found by "equivalence scales" that reflect the mix of economies of scale and out of pocket marginal costs of extra family members. The generally accepted, widely used scales are as follows:

First adult of either sex	1.0
Other adults	0.4 each
First child to a single-parent household	0.4
Other children	0.3 each

The reference family of two parents and two children can be found by this formula to be equivalent to two single adults (1.0 + 0.4 + 0.3 + 0.3 = 2.0). The single adult cost of non-discretionary consumption is therefore **$11,000. This, therefore, should be the minimum basic allowance.**

Extra adults each add another 40% to the non-discretionary consumption amount, which is **$4,400**. So does the first child in a single parent household. **That value should be the minimum allowance for the spouse,** and for the first child in a single parent household.

Extra children add **$3,300** each, other than the special case above. **Therefore, that value should be the minimum extra allowance for each extra child**.

Appendix F: Alternative Income Tax Models

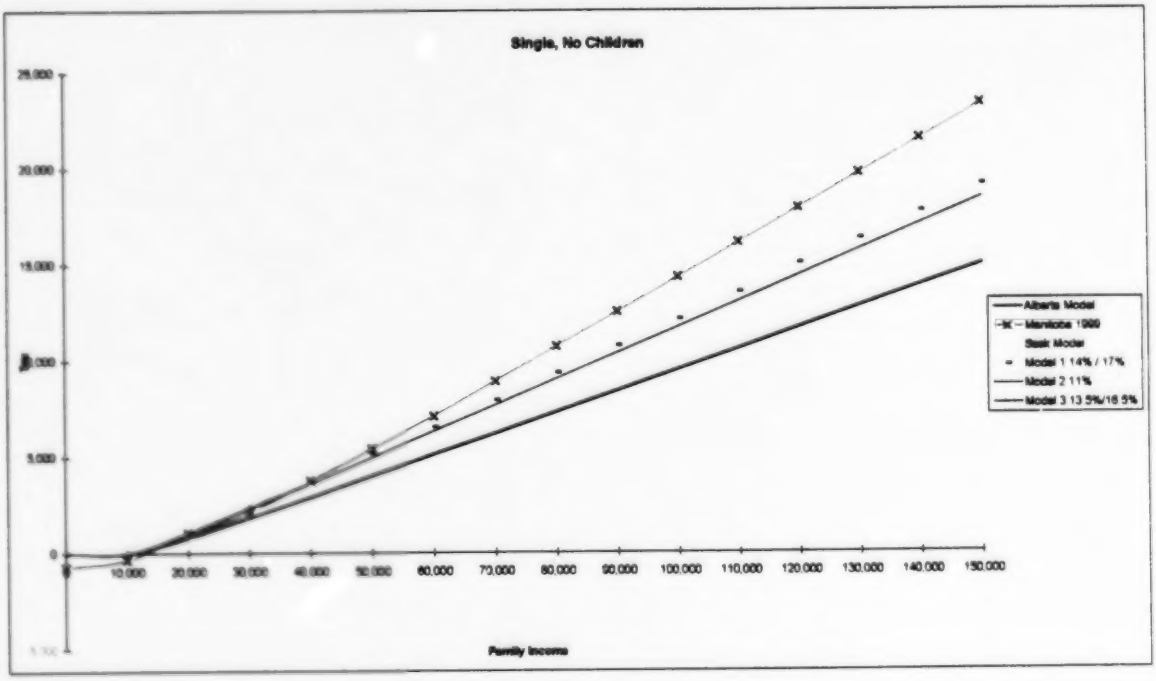
The following pages show tables and graphs which compare the results of 14 different income tax models for five different families, at a range of different income levels. The 14 income tax models consist of:

- the current (1999) Tax on Tax structures for each province except Quebec;
- the Tax on Income Models proposed by Alberta and Saskatchewan Tax Commissions;
- Models 1 and 2 recommended by this Commission;
- a Model 3, with rates of 13.5% and 16.5% and the same exemption levels as Models 1 and 2. This was not recommended by the Commission only because of present budget deficit considerations.

These tables and graphs show clearly what the Commission's recommendations mean to typical Manitoban households. Under Model 1 most Manitobans will be paying more tax than has been proposed for people in similar circumstances in Alberta and Saskatchewan, but less than they are paying now. Model 2 would have all Manitobans paying even less than Model 1.

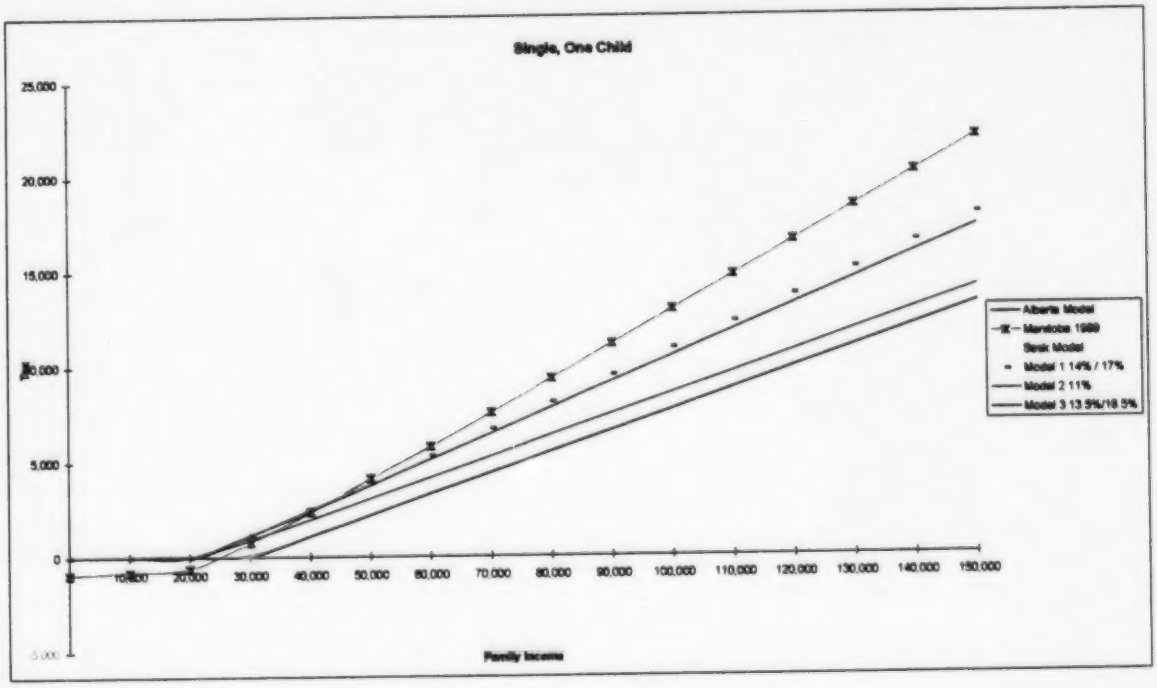
Single, No Children

Family Income	BC 1999	Alberta 1999	Sask 1999	Manitoba 1999	Ontario 1999	NB 1999	NS 1999	PEI 1999	Nfld 1999	Alberta Model	Sask Model	Model 1 14% / 17%	Model 2 11%	Model 3 13.5%/16.5%
0	-50	0	0	-715	-500	0	0	0	0	0	0	0	0	0
10,000	163	0	207	-336	-172	274	127	271	315	0	111	0	0	0
20,000	1,020	1,006	1,389	1,044	834	1,271	1,218	1,260	1,461	798	1,141	1,103	936	1,064
30,000	1,829	1,775	2,461	2,142	1,496	2,251	2,157	2,232	2,589	1,829	2,172	2,415	1,897	2,329
40,000	3,075	2,933	4,009	3,782	2,516	3,761	3,604	3,730	4,325	2,872	3,315	3,740	2,940	3,609
50,000	4,382	4,157	5,787	5,423	3,569	5,321	5,099	5,285	6,119	3,972	4,615	5,144	4,040	4,969
60,000	5,789	5,464	7,611	7,098	4,789	6,896	6,609	7,002	7,933	5,072	5,915	6,542	5,140	6,309
70,000	7,636	6,982	9,601	8,933	6,560	8,636	8,276	8,900	10,134	6,172	7,215	7,942	6,240	7,669
80,000	9,501	8,310	11,591	10,709	8,393	10,376	9,944	10,798	12,336	7,272	8,515	9,346	7,340	9,009
90,000	11,818	9,739	13,581	12,518	10,225	12,116	11,772	12,696	14,537	8,372	9,815	10,742	8,440	10,369
100,000	13,755	11,167	15,571	14,322	12,057	13,884	13,606	14,595	16,738	9,472	11,115	12,142	9,540	11,709
110,000	15,894	12,595	17,561	16,129	13,889	15,764	15,441	16,493	18,939	10,572	12,615	13,942	10,640	13,059
120,000	18,032	14,023	19,551	17,935	15,721	17,643	17,275	18,391	21,140	11,672	14,115	15,042	11,740	14,409
130,000	20,171	15,451	21,541	19,742	17,554	19,552	19,109	20,289	23,341	12,772	15,615	16,342	12,840	15,759
140,000	22,310	16,879	23,531	21,548	19,386	21,401	20,943	22,187	25,542	13,872	17,115	17,742	13,940	17,109
150,000	24,448	18,307	25,521	23,355	21,218	23,260	22,776	24,085	27,743	14,972	18,615	19,142	15,040	18,459



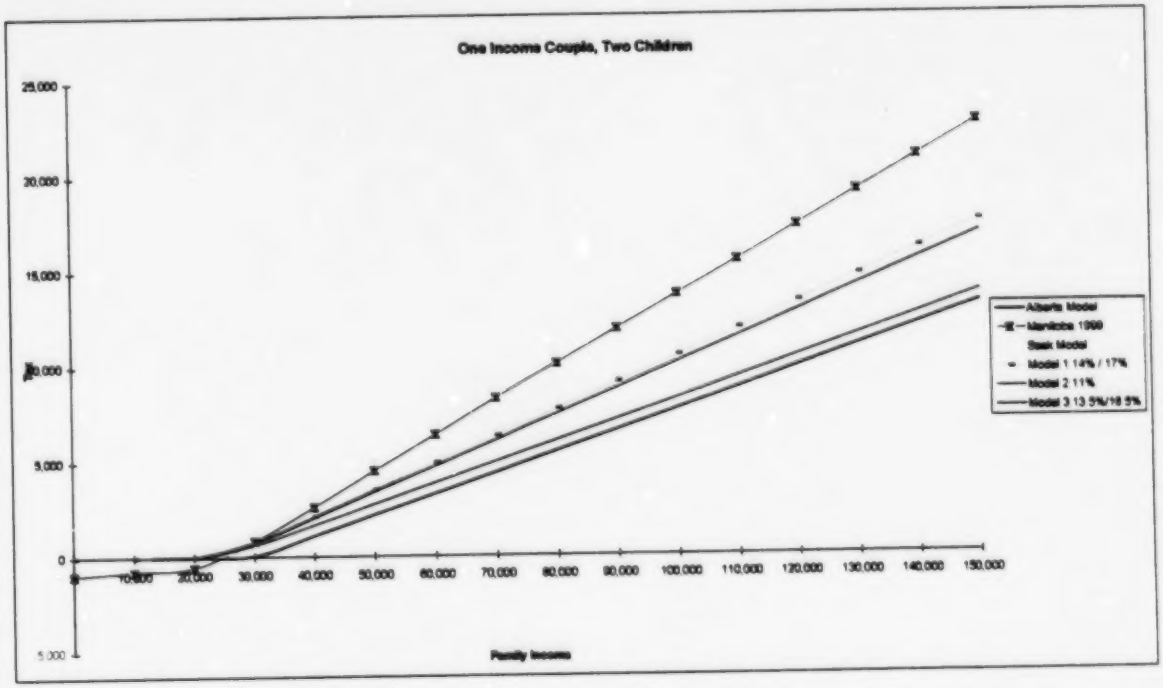
Single, One Child

Family Income	BC 1999	Alberta 1999	Sask 1999	Manitoba 1999	Ontario 1999	NB 1999	NS 1999	PEI 1999	Nfld 1999	Alberta Model	Sask Model	Model 1 14% / 17%	Model 2 11%	Model 3 13.5%/16.5%
0	-100	0	0	-905	-550	0	0	0	0	0	0	0	0	0
10,000	-100	0	0	-793	-487	0	0	0	0	0	0	0	0	0
20,000	80	426	246	-593	-87	256	0	253	294	0	0	0	0	0
30,000	956	502	1,140	768	783	1,230	808	1,219	1,414	65	751	1,180	927	1,136
40,000	2,025	1,901	2,793	2,345	1,657	2,524	2,418	2,502	2,902	1,108	1,806	2,507	1,970	2,418
50,000	3,312	3,172	4,404	4,118	2,170	4,084	3,913	4,049	4,686	2,208	3,106	3,907	3,070	3,766
60,000	4,599	4,413	6,214	5,779	3,763	5,644	5,408	5,636	6,460	3,308	4,406	5,307	4,170	5,116
70,000	6,136	5,790	8,139	7,534	5,137	7,319	7,014	7,464	8,466	4,408	5,706	6,707	5,270	6,466
80,000	8,002	7,218	10,129	9,340	6,989	9,059	8,681	9,362	10,668	5,508	7,006	8,107	6,370	7,816
90,000	9,904	8,646	12,119	11,147	8,802	10,799	10,384	11,260	12,870	6,608	8,306	9,507	7,470	9,166
100,000	12,043	10,074	14,109	12,953	10,634	12,539	12,218	13,158	15,072	7,708	9,606	10,907	8,570	10,516
110,000	14,182	11,502	16,099	14,760	12,466	14,341	14,052	15,056	17,273	8,808	11,017	12,307	9,670	11,866
120,000	16,321	12,930	18,089	16,566	14,298	16,220	15,886	16,954	19,474	9,908	12,517	13,707	10,770	13,216
130,000	18,460	14,358	20,079	18,373	16,130	18,099	17,721	18,852	21,675	11,008	14,017	15,107	11,870	14,566
140,000	20,599	15,786	22,069	20,179	17,953	19,979	19,555	20,750	23,876	12,108	15,517	16,507	12,970	15,916
150,000	22,738	17,214	24,059	21,986	19,795	21,858	21,389	22,648	26,077	13,208	17,017	17,907	14,070	17,266



One Income Couple, Two Children

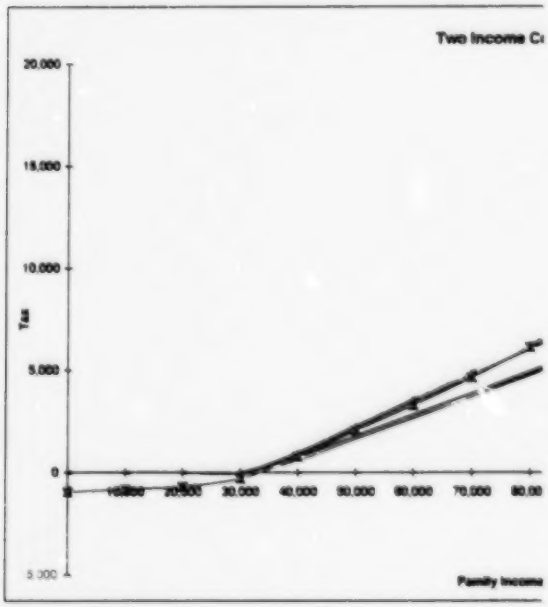
Family Income	BC 1999	Alberta 1999	Sask 1999	Manitoba 1999	Ontario 1999	NB 1999	NS 1999	PEI 1999	Nfld 1999	Alberta Model	Sask Model	Model 1 14% / 17%	Model 2 11%	Model 3 13.5%/16.5%
0	-200	0	0	-955	-700	0	0	0	0	0	0	0	0	0
10,000	-200	0	0	-755	-460	0	0	0	0	0	0	0	0	0
20,000	307	395	391	-555	-60	845	0	639	741	0	0	0	0	0
30,000	1,252	1,334	1,892	825	885	1,666	1,416	1,652	1,916	57	429	795	625	765
40,000	2,593	2,505	3,346	2,611	2,122	3,212	3,079	3,186	3,694	1,100	1,569	2,122	1,667	2,046
50,000	3,880	3,699	5,053	4,502	3,175	4,772	4,574	4,733	5,486	2,200	2,869	3,522	2,767	3,396
60,000	5,180	4,992	6,878	6,375	4,316	6,347	6,083	6,404	7,298	3,300	4,169	4,922	3,867	4,746
70,000	6,660	6,420	8,668	8,281	5,946	8,087	7,750	8,302	9,440	4,400	5,469	6,322	4,967	6,096
80,000	8,726	7,849	10,668	10,088	7,778	9,827	9,418	10,200	11,641	5,500	6,769	7,722	6,067	7,446
90,000	10,749	9,277	12,848	11,894	9,611	11,567	11,194	12,098	13,842	6,600	8,069	9,122	7,167	8,796
100,000	12,888	10,705	14,838	13,701	11,443	13,307	13,028	13,996	16,044	7,700	9,369	10,522	8,267	10,146
110,000	15,027	12,133	16,828	15,507	13,275	15,171	14,882	15,894	18,245	8,800	10,669	11,922	9,367	11,496
120,000	17,165	13,561	18,818	17,314	15,107	17,050	16,696	17,792	20,446	9,900	12,369	13,322	10,467	12,846
130,000	19,304	14,989	20,808	19,120	16,939	18,929	18,531	19,690	22,647	11,000	13,869	14,722	11,567	14,196
140,000	21,443	16,417	22,798	20,927	18,772	20,809	20,365	21,588	24,848	12,100	15,369	16,122	12,667	15,546
150,000	23,582	17,845	24,788	22,733	20,604	22,688	22,199	23,486	27,049	13,200	16,869	17,522	13,767	16,896

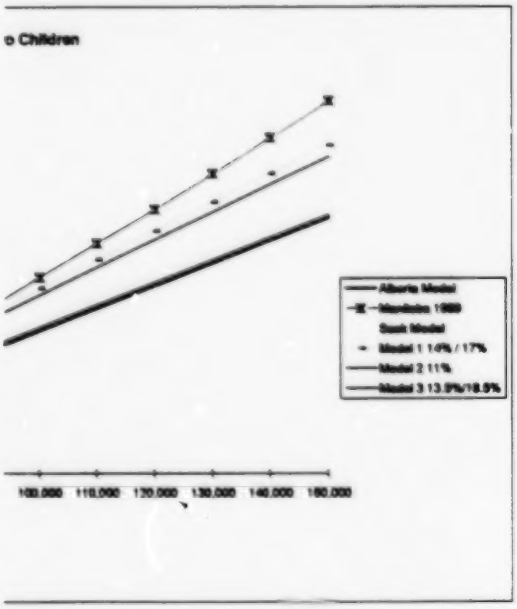


Two Income Couple, Two Children

Family Income	BC 1999	Alberta 1999	Sask 1999	Manitoba 1999	Ontario 1999	NB 1999
0	-200	0	0	-955	-700	0
10,000	-200	-560	-3	-822	-593	0
20,000	-200	-1,000	-7	-688	-327	0
30,000	384	-539	104	-289	-13	719
40,000	1,226	257	1,225	775	327	1,606
50,000	2,081	1,609	2,629	2,058	1,633	2,585
60,000	2,896	2,830	3,919	3,274	2,369	3,579
70,000	3,909	3,781	5,215	4,624	3,198	4,807
80,000	5,012	4,811	6,612	6,128	4,101	6,145
90,000	6,299	6,005	8,281	7,889	5,154	7,705
100,000	7,586	7,229	9,982	9,580	6,207	9,265
110,000	8,873	8,469	11,765	11,241	7,310	10,825
120,000	10,173	9,781	13,610	12,914	8,480	12,399
130,000	11,707	11,118	15,510	14,648	9,937	14,049
140,000	13,472	12,503	17,445	16,410	11,514	15,735
150,000	15,338	13,931	19,435	18,217	13,335	17,475

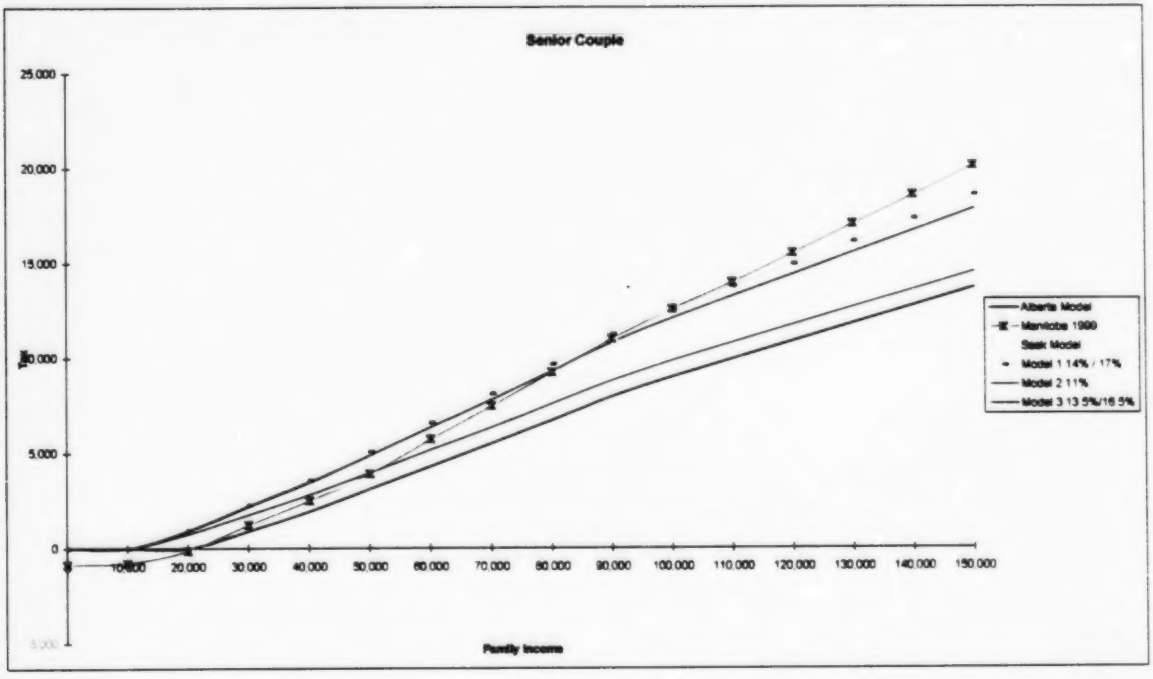
PEI 1999	Nfld 1999	Alberta Model	Sask Model	Model 1 14% / 17%	Model 2 11%	Model 3 13.5%/18.5%
0	0	0	0	0	0	0
0	0	0	0	0	0	0
0	0	0	0	0	0	0
713	827	0	0	0	0	0
1,593	1,847	632	851	969	781	934
2,584	2,973	1,656	1,882	2,281	1,782	2,199
3,549	4,118	2,696	2,713	3,593	2,823	3,464
4,767	5,528	3,717	3,743	4,904	3,853	4,729
6,093	7,066	4,772	4,898	6,247	4,908	6,024
7,640	8,860	5,872	6,122	7,847	6,008	7,374
9,195	10,654	6,972	7,422	9,047	7,108	8,724
10,819	12,448	8,072	8,722	10,447	8,208	10,074
12,486	14,262	9,172	10,022	11,847	9,308	11,424
14,285	16,260	10,272	11,322	13,247	10,408	12,774
16,124	18,325	11,372	12,622	14,647	11,508	14,124
18,022	20,526	12,472	13,922	16,047	12,608	15,474





Senior Couple

Family Income	BC 1999	Alberta 1999	Sask 1999	Manitoba 1999	Ontario 1999	NB 1999	NS 1999	PEI 1999	Nfld 1999	Alberta Model	Sask Model	Model 1 14% / 17%	Model 2 11%	Model 3 13.5%/16.5%
0	-86	0	-10	-851	-850	0	0	0	0	0	0	0	0	0
10,000	-6	0	20	-771	-821	0	0	0	0	0	0	0	0	0
20,000	698	295	676	142	40	897	859	889	1,031	0	574	955	750	921
30,000	1,504	1,445	2,058	1,223	1,100	1,892	1,813	1,876	2,175	918	1,605	2,286	1,761	2,186
40,000	2,294	2,289	3,247	2,497	1,877	2,850	2,731	2,826	3,277	1,949	2,636	3,578	2,812	3,450
50,000	3,224	3,166	4,458	3,908	2,638	3,977	3,811	3,943	4,573	3,117	3,805	5,065	3,980	4,864
60,000	4,586	4,426	6,132	5,743	3,752	5,628	5,393	5,581	6,472	4,313	5,003	6,587	5,175	6,352
70,000	5,948	5,687	7,805	7,478	4,867	7,279	6,976	7,218	8,371	5,509	6,398	8,109	6,371	7,819
80,000	7,330	6,966	9,635	9,232	5,986	8,954	8,581	8,880	10,297	6,728	7,818	9,661	7,591	9,316
90,000	8,722	8,313	11,572	10,995	7,136	10,641	10,197	10,567	12,237	7,962	9,252	11,231	8,824	10,830
100,000	9,940	9,530	13,285	12,567	8,221	12,118	11,613	12,178	13,935	9,000	10,479	12,553	9,863	12,104
110,000	11,114	10,622	14,823	13,979	9,295	13,444	12,883	13,625	15,480	9,935	11,584	13,747	10,798	13,252
120,000	12,693	11,831	16,508	15,509	10,639	14,915	14,294	15,230	17,266	10,870	12,669	14,933	11,733	14,399
130,000	14,279	13,044	18,199	17,045	12,197	16,394	15,711	16,843	19,159	11,805	13,794	16,123	12,668	15,547
140,000	15,865	14,258	19,891	18,580	13,754	17,873	17,129	18,457	21,030	12,740	14,899	17,313	13,603	16,694
150,000	17,451	15,472	21,582	20,116	15,311	19,352	18,546	20,070	22,901	13,675	16,004	18,563	14,538	17,842



Appendix G: Glossary of Terms

Average Tax Rates: Total tax paid divided by total income earned.

Business Inputs: Goods purchased by businesses for their own use, rather than for reprocessing and/or resale.

Discretionary Income: Disposable income available for consumption and savings after taxes and the necessities of life are paid for.

Disposable Income: Real, after-tax income available to pay for the necessities of life.

Equity: Impartial treatment of all taxpayers, regardless of their circumstances.

Horizontal Fairness: Equal tax treatment of individuals or households having the same circumstances and the same income, regardless of the source of that income.

Marginal Tax Rates: The tax paid on the last dollar of income earned. High marginal rates discourage taxpayers from working harder to earn and save more.

Neutrality: Equal tax treatment among different types of economic activity.

Non-discretionary Income: Disposable income that is required to pay for the necessities of life.

Non-Refundable Tax Credits: A tax credit that is useable by the tax filer only to the extent they whether taxes are payable or not. They are currently used to recognize individual circumstances that affect the level of disposable income.

Portion: The part of assessed property value that is subject to property tax.

Productivity: Output produced per unit of labor input provided.

Progressive Tax: A tax system where the proportion of income taken in tax rises with income.

Refundable Tax Credits: A tax credit that is useable by the tax filer whether taxes are payable or not. They are currently used to redistribute money to those with little or no income, based upon targeted circumstances.

Service Gap: Difference between government spending programs available in Manitoba and some other province.

Tax Base: What is eligible to be taxed. For example, the income tax base is the total income of all taxpayers on which an income tax is levied, or the total consumption of all taxpayers on which a consumption tax is levied.

Tax Gap: Difference in tax rates between Manitoba and some other province. Usually refers to difference in marginal personal income tax rate.

Tax Mix: The relative weight proportion of the total tax burden.

Tax Incidence: The body of analysis that predicts how much of the burden of any tax will be borne by various groups of taxpayers.

Tax Mix: The relative weight proportion of the total tax burden.

Vertical Fairness: Equal tax treatment of individuals or households having the same circumstances, regardless of level of income.

Appendix H: List of Submitters

W. A. Addison
Bruce Alexander
Richard Alsh
John Alteitz
Alma M. Anderson
Doris Andres
Brian Ardern
Tom Aris
Gabriel Attallah
Thomas S. Axworthy
Mike Babinsky
Elaine Bailey
William Balacko
Sylvain Baril
Tom Barnes
Robert Barr
Emily Barrett
Hans & Ingeborg Barthel
Ms Bates
Dave Bears
Denis Beaulieu
Gwen Beelaert
Dan Belhassen
Annette Bell
Del Belluk
Keith A. M. Bernier
Hardo Bewer
William Birk
Candace Bishoff
Peter Bjornson
Lawrence Blair
Charles & Joanne Bobrowich
Edie Boehmer-Kent
Henry Boschmann
Garnet Boutet
Patrick Bowman
Nelson & Stephanie Brandao
Rob Bray
Gordon Breise
Kerry Brewer
M. G. Britton
Dorothy Broughton
Don & Anne Brow
Lynda Brown
Mavis Brown
Brett Brown
Jeffrey T. Brown
Dan Brunel
G E Buchanan
George Buchholz
Ernest Buhler
Roland Buly
Dawn Burling
John Burrin
Janice Burton

Paul Busjois
Roy Butler
Robert & Lisa Byle
Ms Cadotte
Marjorie Cameron
Audrey Campbell
Nick Carter
Kerry Cazzorla
Marcel Chabidon
Gerard Chagnon
Debbie Chalus
Ron Chercoe
Rosalee Chmidt
Diane Circo
Jim and Dorothy Clark
James M. Clark
Stephen Cocks
Gary Cockshott
Marguerite Cory
Rhonda Coupland
Dianna Coutu
Janet Cowrie
Martin Cox
Brian Crow
Helen Curry
Leo Cyr
Arlene Dahl
Allan Dales
Charles Dalrymple
Charlie Dalrymple
J & R Davidson
Jeannette Davis
Pat Davy
Bev Dawkins
Helen (Brikin) Delaney
Brigitte Deleeuw
A. Dennis
Earl Dettrich
George Dewandel
A. Dewar
Ken Deyell
Angus Dickson
Donald Dilley
Joe Dolecki
Sanny Dost
John Doyle
William Dugas
Reg Dumas
L. H. Dyck
Jacob Dyck
Dave Dyck
Lloyd Dyer
Don Ellis
Richard Ellis
Ray Elson

Perry Exley
Bill Fardoe
Albert Farris
E. Fast
Steve Fedorchuk
Ken & Judith Fehr
Marcien & Brenda Ferland
Norm Fisher
Warren Flannery
Ken Forsyth
Edna, Patricia, Verla and Gail Fortier
Denise Francis
Mark Francis
Larry Friesen
Trevor Friesen
Kenton Frieson
Mr Fullerton
Myrna Garrioch
Armand Gautron
Mary Gavel
Julie Geifel
Ian Gent
R. Gerelus
A. Giesbrecht
Peter Gilberd
Anna & Richard Girulski
Ron Golbeilski
Sheldon Goldberg
Dale Gorrell
Rose Gosselin
John M. Granelli
George & Mabel Grant
W. E. Gratton
Patricia Graupner
Dorothy Gregory
John Gural
Debora Haliburton
R. C. Hanashuak
W.R. Hanson
Norman Harde
Norman A. Harde
Marianne Harder
George Hargreaves
Wayne Harrett
Del Harrison
Floyd Harrison
Harold Hart
Eldon Hearn
Neil Heinrichs
Dave Henderson
W. R. Henson
Terrence Hickenbottom
Peter Hildebrand
F Hinings
Valerie Holm

Roberta Hoogervoorst
Gary Hooper
Kim Horner
Ed Horton
Denis Hosking
Fred Howard
Rick Howard
A Huey
Harold Hunter
Dick Hunter
D. L. Hurst
Jacqueline Hutchinson
Ron Irwin
Stephen Ishmael
Pablo Jajalla
Trish Jansen
Stella Johnson
Karen Johnson
Mark Johnson
John Johnson
Sandra Johnston
Sandra Johnston
K. W. Jones
Doris Jones
William Kandia
Tim Kathler
E. Katz
Clay Kemp
David Kennedy
Bob Kennedy
Werner Kettner
Chris King
Alfred Klassen
Jack Klassen
John H. Klassen
Neil Kleinsteuber
Tim Klippenstein
Adele Korolyk
Lillian Kowalchuk
Dave Krems
Derek Kroeker
B. Kroemer
Connie and Rolf Krohn
Lutz Krohn
Frank Kuersen
R. Kulak
Ralph Kuropatwa
J. Kwakernaak
Francis Kwasny
Claude Laberge
Glenda Lagadi
Betty Laing
Betty M. Laing
Joanne Lamarre
Doug Lamb

Dwayne Lanctot
Doreen & Bill Langdon
Dale Langille
Eric Lansky
Janet Laurie
Janet Laurie
Dave Lavich
Marvin M. Lavitt
Harry & Norma Laws
Allan Leach
Sharon Leckie
Tim Lehman
Karen P. LeMay
Jim Lengyel
Peter Lep
Shawn Leslie
Rheal Monique Lessier
Jake Letkeman
Elliot Leven
K. Lindbeck
Lois Loganberg
John C. Long
W Lord
Zeeba Loxley
Michael Luke
Bob Lundgren
B Lutz
Norman and Edith MacDonald
R. G. MacDonald
Ken MacDonald
Laurie MacIntosh
Mrs Mackenzie
E. M. Mackenzie
Dale Madill
Jayesh Maniar
Dianne & Ray Mariash
Dollard Marion
G. A. Martin
Heather Martin
William Martin
Isabel Martinez-Welgan
Darren Martins
J Mazur
James McCowan
Maxie McGinness
Harvey L. McIntyre
Dave McKenzie
Linda McMillan
Dereck Meek
Marta Menier
W. Mialkowski
Mr Mintenko
Terry Mitchell
Bert Mitchell
Bruce Mogg

List of Submitters (Continued)

Hank Monita
Walter Mrak
Len Mullen
Ursula Muller
Norman J Nagel
Norman Nagle
Ken Nemeth
Grant Nerbas
Ken Nero
John W. Norberg
Eldon Normandin
Morris Normandin
Brian Norris
Carol Nowell
B O'Callaghan
Issie D Oiring
John Olson
Betty O'Malley
Carl Orcutt
Art Orme
Leroy Osmond
G & K Owzarek
Ed Paquette
E Paquette
Esther Paradoski
Lucy Parlie
Norma Pavely
Dianne Pelletier
Vivian Penner
George Penner
Darryl Penner
Ben Penner
Wilmer Penner
Vernon Penner
Dianna Pennington
Lawrence Perron
Jennifer Peters
Fred Petrie
Ruth Pierce
Albert Podzorski
Nick Poetker
Tanis Popovitch
Mr Porth
Max Pressman
Joan Price
Jeff Pries
Mr Prohaska
Jim Proven
Stacy Pruden
John Pruse
Bob Purdy
Bruce Purdy
Guy Quenneville
Gail Radtke
John Rapstead
Maria Rego
Don Reimer
Harry Rempel
Lorne Renward
T Richmond
R Riehl
Judy Riley
Diane Rindall
Glynnis & Michael Ringham
na and William Ritchie
Ken Ritchie
Mrs Robertson
Duff Roblin
Jules Rocque
Darcy G. Rollins
Jules Roque
Reta J. Ross
Dorothy Rudd
Lori Ryan
Sandy Ryland
George S. Sagi
Alex Salki
Alex Salki
Mike Sambork
David Sanders
Keith Sanderson
Brent Sanderson
Sherry Sanford
Dennis Savard
Rosalie Schmidt
Bill Schmitke
Graham Schofield
Warren Schuetz
Dieter H. Schwanke
Bernice Schwartz
Tracie Scott
Ann Sedowiuk
Gordon B. Sefton
S. Sellers
Robert Selman
Sebastina Semotok
Doug Setter
Jim Shanks
D. M. Sharpe
Dick Sheppard
Frank Sherlock
Sergei Sherman
Judy Shigeta
Gary Shingleton
David Shronson
Barry Shtatleman
Mr Silver
Gary Simonson
Edward & Mary Siwak
Priscilla Sladicka
Ruth Slink
Roger Smith
David Smith
Bertha Smith
Connie Smith
David Smith
Tony Snihur
G Soprovich
Catherine Spalding
Annete Spinak
Muriel St. Johns
Kirk Stanley
Ray Stasiuk
Marvin Stasiuk
Kathleen Sterna
Larry Stowe
Brian Sumner
Kerry Sveinson
Dennis Sweatman
Mr. & Mrs. Tank
Earl Taves
Brian Taylor
Tina Tekerik
J. Andrew Telford
Leanne Teller
Louey Tetreault
Phyllis Thompson
Millie Thompson
T. B. Thorvaldson
Mr Thorveldson
Doug Tiffin
E. B. Tinkler
E. V. Titheridge
Orlando Tobiaos
Ernie Tomchuk
Michael Tucker
Doug Turner
Stephen R. Turney
Rose Ursel
Leah Vaccina
A.K. Valgardson
John Vander Kooy
Terry Vanhantsaeme
Rosemary VanRosmalen
Claude Veshier
M. J. Vogt
Anthonie Vonk
Joanna Vreeland
Howard Wagner
Sara Wall
Carl Walls
Desmond Walton
Alec Warga
Michael Warren
Len Warren
Al Weins
S West
Horst Wichert
Joyce Wilk
D. N. Wilson
Phyllis Wiscombe
Donna Wittevrongel
Andrew Wong
Fred Wonky
Grant Wright
Mary Wright
Elaine Wright
Robert E. Wrigley
Dave Yallits
Lance Yaschyshyn
Rod Yellon
Kevin Young
Mr Zahn
Halina Zloty
C. Zmola

RM of Alexander
Sandy Bay Property Owners' Association
Brandon Chamber of Commerce
Brandon School Division
Keystone Agricultural Producers
Association of Manitoba Municipalities
Manitoba Association of School Trustees
Canadian Taxpayers Federation
Canadian Union of Public Employees
Manitoba Association of Cottage Owners
Manitoba Teachers Society
Winnipeg Chamber of Commerce
Manitoba Federation of Labor
Concerned Condo Owners of Manitoba
Canadian Federation of Independent Business
RM of West St. Paul
Retired Teachers Association of Manitoba
Canadian Bankers Association
Various Victoria Beach Cottage Owners

Appendix I: Biographies of the Commission Members

CLAYTON MANNESS, Chairman

Clayton Manness is President of Man Agra Capital Inc., a company that sources capital for and leads development of value-added agricultural businesses. He, and his family, also own and operate a modern grain and oilseeds farm operation in the Red River Valley. Clayton has engaged himself in a wide range of activities after having completed a M.Sc. degree in Agricultural Economics. He has been employed by the Manitoba Department of Agriculture, Cargill Grain Ltd., and the Canada Grains Council. He has also devoted a significant number of years to public life in many respects, including MLA, Minister of Finance and Education, Government House Leader, and Chairman of Treasury Board. Upon leaving elected office, he has subsequently chaired a City of Winnipeg Committee on Tax Reform, and acts as a Public Governor, Canadian Investment Protection Fund.

DR. NORMAN CAMERON, Commissioner

Dr. Norman Cameron is Professor of Economics at St. John's College at the University of Manitoba, where he has lectured since 1969. His teaching and research interests are in macroeconomics and government stabilization policy, both provincial and federal. He is a founding member of the Investment Advisory Board of the Crocus Fund. He was awarded a 3M Fellowship for Excellence in Teaching and Educational Leadership in 1994.

EVELYN JACKS, Commissioner

Evelyn Jacks is President of The Jacks Institute, a national private vocational school specializing in tax and tax accounting courses for professionals in the tax and financial services industries, and Director of Education for CCH Canadian Ltd. She is also Canada's best-selling author of close to 30 books on personal income tax preparation and planning, and the author of over 70 certificate courses in professional tax accounting. She is also engaged frequently on national speaking tours and is a nationally known columnist and commentator on federal and provincial tax issues. Evelyn is also the recipient of numerous awards including the National Canadian Entrepreneur of the Year Award, The Manitoba Business Woman of the Year Award and recently with a Business Leadership Award presented by the Canadian Embassy in Washington.

WILLIAM EVA, Secretary to the to the Commission

William Eva is self-employed as a financial analyst, assisting clients with a variety of financial, managerial and taxation issues. He formerly worked with the Government of Manitoba, in the Departments of Finance and Executive Council.